72-51

Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1972

No. .....

In the Matter
of
ABNER MICHAUD and ALYCE E. MICHAUD,
Bankrupts, JOHN V. BOWSER, Trustee
in Bankruptcy,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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INDEX.

	PAGE
Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit	1
Opinions Below	2
Jurisdiction	2
Question Presented	2
Statutory Provisions Involved	2
Statement of the Case	3
Reasons for Granting the Writ	4
Discussion	5
The Court of Appeals has misinterpreted the 1966 amendments to the Bankruptcy Act, has overlooked clear legislative history after stating there was none, and has failed to accord said amendments the meaning intended by Congress, thereby (1) denying the relief intended for honest debtors and (2) denying an equitable division of the bankrupt's assets among his creditors	5
Conclusion	13

TABLE OF CASES.

Colony, Inc. v. Commissioner, 357 U. S. 28 [1 AFTR 2d 1894] (1958)	8
Davis v. Hightower, 230 F. 2d 549 [49 AFTR 277], 5 Cir. (1956)	8, 9
Deakman-Wells Co., Inc. v. C. I. R., 213 F. 2d 894 [45 AFTR 1666], 3 Cir. (1954) (Maris, J.)	9
Genevieve B. Walker, 46.65 P-H T. C. 449 (1957)	9
In re Indian Lakes Estates, Inc., 428 Fed. 319 (5 Cir. 1970) *cert. denied* 400 U. S. 964	5, 7, 9
Uptegrove Lumber Co. v. C. I. R., 204 F. 2d 570 [43 AFTR 948], 3 Cir. (1953) (Hastie, J.)	9

STATUTES.

PAGE

28 U. S. C. 1254 (1) 2

Bankruptcy Act [11 U. S. C. 35 and 104 as amended by Secs. 2 and 3, Act of July 5, 1966, P. L. 89-496, 80 Stat. 270]:

Section 17 ..... 2, 62a
Section 17a 3
Section 17a(1), clause (c) 3, 4, 10, 11
Section 64 ..... 2, 3, 63a
1966 Amendments 5

Internal Revenue Code of 1954:

Sections 6501 (a) and (e) 2, 8, 10, 63a, 64a

MISCELLANEOUS.

Senate Report No. 1158 to the 89th Congress, Second Session (1966) 6, 10, 65a
Page 3 8

Senate Report No. 999 to the 89th Congress, Second Session 9, 10

50 Am. Jur. 210, 415, 420 11

INDEX TO APPENDICES.

A—Opinion of the Court, United States Court of Appeals for the Third Circuit, No. 71-1165 (Filed April 10, 1972) 1a

B—Opinion of Weber, J., Dated October 1, 1970 ..... 15a

C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969) 31a

D—Bankruptcy Act Section 17 and Section 64. Also Internal Revenue Code of 1954 (26 U. S. C.): Sections 6501(a) and (e) 62a

E—Senate Report No. 1158 to the 89th Congress (1966) 65a

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UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Petitioners are John V. Bowser, the Trustee in Bankruptcy in the Matter of Abner Michaud and Alyce E. Michaud, Bankrupts, and the Bankrupts. The Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit.

Opinions Below

The opinion of the Court of Appeals (April 10, 1972) (Appendix A, *infra*, p. 1a) is reported at 458 F. 2d 953. The opinion and order of the District Court for the Western District of Pennsylvania (October 1, 1970) (Appendix B, *infra*, p. 15a) affirming the order of the Referee is reported at 317 F. Supp. 1002. The Memorandum and Order of the Referee in Bankruptcy (October 10, 1969) (Appendix C. *infra*, p. 31a) is reported at 24 AFTR 2d 69-5978.

Jurisdiction

The judgment of the Court of Appeals for the Third Circuit was entered on April 10, 1972, and this petition for certiorari was filed within 90 days of that date. The court's jurisdiction is invoked under 28 U. S. C. 1254 (1).

Question Presented

Whether income tax deficiencies legally due and owing for more than three years before bankruptcy but not assessed prior thereto because of the pendency of appellate remedies of the taxpayer in the Tax Court of the United States, were discharged in bankruptcy and, therefore, relegated to the status of general claims when the amount of the taxpayer's gross income and the bases for the disallowed deductions constituting said deficiencies were set forth in the taxpayer's returns.

Statutory Provisions Involved

The pertinent provisions of Sections 17 and 64 of the Bankruptcy Act [11 U. S. C. 35 and 104 as amended by Secs. 2 and 3, Act of July 5, 1966, P. L. 89-496, 80 Stat. 270] and Sections 6501 (a) and (e) of the Internal Revenue Code of 1954 are set forth in Appendix D, *infra*, p. 62a.

Statement of the Case

Remedial legislation was enacted by Congress in 1966, amending the Bankruptcy Act (Sec. 17a) to provide for discharge of federal taxes which became legally due and owing more than three (3) years preceding bankruptcy, and to provide (Sec. 64) that taxes which are so discharged would have no priority over general unsecured creditors.

Abner Michaud for over 20 years conducted a meat processing and distributing business and filed income tax returns showing all gross income and claiming as a business deduction 3% commissions or sales promotion expenses paid to chefs, purchasing agents and other customer representatives. The practice was known to the I. R. S., and not questioned on annual examination. In 1958 the I. R. S. instituted a policy of questioning such deductions as "kickbacks", and ultimately found deficiencies for the years 1955 through 1960.

The issue of the existence of any deficiency pending before the Tax Court on the date of bankruptcy was transferred to and litigated before the Referee in Bankruptcy along with the question here presented. The Referee found that the deductions should be disallowed, resulting in a tax deficiency for 1955 through 1960 of $94,652.73, but that the government was not entitled to priority of payment thereof on the ground that the bankrupt was discharged from liability therefor by reason of having reported his gross income and the bases and amounts of the deductions whose disallowance resulted in the claimed deficiencies on his returns.

The government contends that the tax deficiencies are not discharged, and are, therefore, not relegated to the status of general claims, under the amended section 17 a (1), clause (c) which states:

> "Provided, however, that a discharge in bankruptcy shall not release a bankrupt from any taxes * * * (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt * * *."

In order to come within Section 17 a (1) (c) exempting the taxes from discharge and hence maintaining their priority position, two requirements must be met: (1) that the taxes were not reported on a return, *and* (2) that the taxes were not assessed by reason of a prohibition on assessment pending exhaustion of administrative or judicial remedies. It is conceded that there was a prohibition on assessment by reason of pending judicial remedies in the Tax Court. The issue therefore turns on whether the taxes in question were taxes not reported on a return. The Bankrupts and the Trustee assert that the tax returns filed by the Bankrupts, setting forth *all* of the taxpayer's income, amounts and bases of the deductions, and tax computations, were an adequate reporting of the taxes under a proper interpretation of the remedial statute in question.

The Referee in Bankruptcy and the District Court construed the remedial statute in accordance with its basic purpose and found for the Trustee and the Bankrupt-taxpayer. The Court of Appeals reversed.

Reasons For Granting the Writ

1. The decision below—denying the Bankrupts a discharge from stale taxes, and allowing stale tax claims to absorb the entire estate in priority over other creditors—is clearly contrary to the intent of Congress in adopting this remedial legislation and denies to the Bankrupt taxpayer the relief intended and denies to creditors of the Bankrupts an equitable division of the Bankrupt's assets.

2. The Court of Appeals has overlooked the clear legislative history and purpose of the 1966 Bankruptcy Act Amendments, after stating that the statutory language in the narrow subsection in question is uncertain, and in need of interpretation.

3. The interpretation of the 1966 Bankruptcy Act Amendments is of great importance in the administration of bankrupt estates by the Federal courts and should be settled by this Court.

DISCUSSION

The Court of Appeals has misinterpreted the 1966 amendments to the Bankruptcy Act, has overlooked clear legislative history after stating there was none, and has failed to accord said amendments the meaning intended by Congress, thereby (1) denying the relief intended for honest debtors and (2) denying an equitable division of the bankrupt's assets among his creditors.

Two Circuit Courts of Appeal, *i. e.,* the Court below in the instant case, and the Fifth Circuit *In re Indian Lakes Estates, Inc.,* 428 Fed. 319 (5 Cir. 1970) *cert. denied* 400 U. S. 964 have stated that there was no legislative history to guide them in interpreting the uncertain wording of the applicable proviso clause of these amendments. BUT, there *was* ample legislative history. The matter of relief for unfortunate debtors, including many of our prominent citizens, from stale and ancient tax claims in bankruptcy had been considered for many years; similar legislation had been passed in the House numerous times only to be held from passage in the Senate Finance Committee and finally passed in 1966 when it was referred to the Senate Committee on the Judiciary

The basic purpose of the amendments is set forth with unmistakable clarity in the report of the Judiciary Committee in Senate Report No. 1158[1]:

"PURPOSE

> The purpose of the bill is to make dischargable in bankruptcy debts for taxes which became legally due and owing more than 3 years preceding bankruptcy, and to limit the priority accorded to taxes in the distribution of bankrupt estates to those taxes which became legally due and owing within 3 years preceding bankruptcy."

and further from S. Rept. 1158, quoting and agreeing with report of the House Judiciary Committee:

> "The fundamental policy of the Bankruptcy Act is to provide a means for (1) the effective rehabilitation of the bankrupt and (2) the equitable distribution of his assets among his creditors. These basic considerations are involved in the problem to which this bill is addressed."

S. Rept. 1158 explains that prior to the amendment, taxes were never discharged in bankruptcy, no matter how stale, that this is "unfairly discriminatory against the private individual or the unincorporated small businessman", that "fairness to individuals demands some time limit upon the extent of taxes excepted from discharge" and that the purpose of the bill is to provide relief for the financially unfortunate.

The report further explains that taxes in bankruptcy, no matter how stale, were entitled to priority over general creditors, often leaving "little or nothing . . . for distribution to general creditors, who provided goods and services

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[1] Senate Report No. 1158 to the 89th Congress, Second Session (1966), is itself such a cogent statement of the purpose of the amendments and its expected impact on existing law, that it is printed in full in Appendix E.

to the bankrupt", and that modification of that status is required.

In the face of this, these two courts say that while the statute is vague, and they need legislative history for guidance, there is none to be found.

The words of the Fifth Circuit in *Indian Lakes* that,

> "This mortal court must attempt to devine the intent of Congress in a situation where that intent may well be known only to the Divine. We must say what Congress meant by two brief phrases in a technical proviso passage of an amendment to the dischargeable debt provisions of the bankruptcy laws when an exhaustive examination by counsel for both parties and this Court of the history of the legislative processes leading to this enactment fails to disclose that the meaning or the significance of the language critical to our decision, was ever really considered."

which were referred to by the Third Circuit Court in the instant case, are indeed colorful and dramatic, but the color and the drama emphasize that the key words "taxes . . . not reported on a return" are ambiguous and uncertain as to the exact meaning and that the court must, therefore, look to the legislative history to learn the congressional intent. We would emphatically agree with both Courts up to that point. But at that point, these two courts floundered in their interpretation by overlooking the basic purpose of the amendments, and the intended effect upon existing law, and erroneously construed the ambiguous language strictly thereby frustrating the express intent of the amendments. The Courts said their construction was a strict one and that only Congress can amend the terminology actually used in the amendment. But query: Is a construction of the words "taxes not reported on a return" to mean "tax liabilities not reported on a return" a strict construction or is it based on interpretation in which (1) the legis-

lative history and (2) the remedial purposes to be accomplished should have been given consideration and followed!

Both Courts saw the need, because of the ambiguity in the amendments, to consult the legislative history for help, and even cited the Committee Reports, and *then* said there was no useful legislative history! By so clearly stating that there was doubt as to the meaning of the clause "taxes . . . not reported on a return" the Fifth Circuit and the Court below eliminated the usual rule that where legislation is clear and unambiguous, Courts have no latitude in interpretation but must give effect to the plain meaning. This should have opened the door to a review of the legislative history and an attempt to interpret the amendments in accordance with their purposes! *Then* the court below concluded by saying that the statutory language was clear and needed no interpretation, and if the exception is too broad "it is Congress, not the courts, which must amend the statute."

The statements at page 3 of Report No. 1158, that – – –

> "It is believed that such a period [3 years] will not impose an unrealistic or unfair burden upon taxing authorities in auditing returns and assessing deficiencies. In fact, the period coincides with the 3 year statute of limitations for assessments in Federal income tax cases." – – –

show that Congress favorably compared the dischargability question to the body of law existing on statute of limitations questions under Section 6501 (a) and (e) of the Internal Revenue Code [26 U. S. C. 6501 (a) and (e)], in which it is uniformly held that full disclosure of the gross income and deductions in question is sufficient to keep them within the operation of the statute, notwithstanding that the computation may be incorrect or made on an erroneous basis: *Colony, Inc. v. Commissioner,* 357 U. S. 28 [1 AFTR 2d 1894] (1958); *Davis v. Hightower,* 230 F. 2d 549 [49 AFTR

277], 5 Cir. (1956); *Deakman-Wells Co., Inc. v. C. I. R.*, 213 F. 2d 894 [45 AFTR 1666], 3 Cir. (1954) (Maris, J.); *Uptegrove Lumber Co. v. C. I. R.*, 204 F. 2d 570 [43 AFTR 948], 3 Cir. (1953) (Hastie, J.); *Genevieve B. Walker*, 46.65 P-H T. C. 449 (1957). As concluded by the District Court below, the two 3 year periods are in *paria materia* and should be given a uniform construction, so that taxes should be construed here as having been reported on a return since all of the gross income was stated as was the basis and amounts of the deductions.[2]

The intention of Congress to allow discharge of stale taxes due and owing for more than three years in a situation such as this where the facts of contested deficiencies are admittedly set forth in the taxpayers' returns, is also apparent from the fact that the Senate Finance Committee in Senate Report No. 999[2] recommended that the words *"date of assessment"* be substituted for the words *"legally due and owing"* in the amendment, and this recommendation was expressly rejected, thus clearly showing that the three year period was intended to begin to run from the time the taxes were due, and not from some subsequent date fortuitously selected.

The courts in *Indian Lakes* and in the instant case have, in practical effect, validated the view of the Senate Finance Committee, a view expressly rejected by the Congress. The Senate Finance Committee's recommendation that the words *"date of assessment"* be substituted for the words *"legally due and owing"*, would have meant that the 3 year period would not begin to run until an assessment had been made. The decision of the court below similarly requires that the assessment in all cases pre-date the bankruptcy, irrespective of whether there is a legitimate dispute be-

[2] Senate Report No. 999 to the 89th Congress, Second Session.

tween the taxpayer and the IRS, so that the taxpayer must always submit to interpretations and deficiencies proposed by I. R. S. in order to gain the benefit of a discharge of a 3 year old tax debt in bankruptcy. The rejection by Congress of language recommended by one of its committees is a persuasive indicator of the legislative intent. Congress adopted the recommendations of the Judiciary Committee first above referred to (S. Rept. 1158 to the 89th Congress, Second Session) and rejected from the amendment the concept recommended by the Finance Committee (S. Rept. 999 to said Congress) that the "assessment" itself was a criterion for dischargeability, and it is error for the courts to write the rejected concept back into the Bankruptcy Act.[3]

The focal point of this case is the meaning of the words "taxes . . . not reported on a return." The meaning is, as both Circuit Courts conceded, not free from doubt. Congress was specific in selecting the date the taxes were "legally due and owing" as the date upon which the 3 year period commenced, and rejected as such the "date of assessment." If Congress intended the words to mean "tax *liabilities* . . . not reported on a return", it could have easily said so; then there would be no ambiguity. But it did not say "liabilities", and there *is* ambiguity, and a clear call to search for the purposes of the legislation, and crystal clear legislative history to show what that legislative purpose was, and the clause in question should be resolved to effectuate those purposes. Certainly it was not the intent of Congress that dischargeability of stale taxes should de-

[3] It is believed the Court of Appeals was in error in giving consideration to the availability of jeopardy assessments, as the assessments prohibited by the pendency of judicial remedies referred to in Section 17a(1)(c) of the Bankruptcy Act are obviously the conventional assessments provided for in Sections 6501 (a) and (e) of the Internal Revenue Code above mentioned, and not jeopardy assessments.

pend upon a correct computation of tax liability where information is fully disclosed - - - especially when there is a difference of opinion between the taxpayer and the I. R. S. as to what is correct computation, and when, as here, the government had agreed with the bases for the taxpayers' computations for a period of years. As pointed out by both the District Court and the Referee, the remedies attempted to be made by the amendment would be nullified in all cases of such differences of opinion as the period could not start to run in the case of a taxpayer who wished to have the validity of his views adjudicated and was unwilling to accept the government's views and forego his administrative and appellate remedies.

The purposes of the amendments are clear, and being remedial in nature the amendments should be given a liberal construction to accomplish the intended purpose, and exceptions should be given a limited construction for the same purpose. 50 Am. Jur. 210, 415, 420, and cases cited.

Not only were the Courts of Appeals wrong in saying there was no legislative history for guidance, but even if there were no legislative history, those Courts would still be wrong because the amendments in question are obviously remedial in nature, the general purposes are clearly expressed and should be given a liberal construction, and the proviso or exception in question should be narrowly construed in order to give full effect to the principal purpose of the amendments in the body of Sec. 17 a(1).

Since the entire bankrupt estate totals only about $75,000 the allowance of the tax claims of $94,000 as priority claims, will absorb the entire estate. Thus, the general creditors will be excluded in favor of tax claims which were due and owing from 5 to 10 years prior to bankruptcy, contrary to

the express purpose of the amendments. Also, contrary to such purpose, the bankrupts will be left with great indebtedness on the old tax claims.

That the Court of Appeals erred in its interpretation of the 1966 amendments is revealed by the anomalous results in applying those Courts' rulings to closely related situations:

(1) A taxpayer who has filed *no* tax returns, but who has been assessed more than a year before bankruptcy, is discharged under Section 17a(1) (b), whereas the bankrupt taxpayer in the instant case remains liable.

(2) A taxpayer whose legal position as to his deductions in tenuous, and who is therefore pressed by IRS for a prompt decision, may be relieved of tax liabilities by an early assessment and a subsequent bankruptcy, whereas a taxpayer with a substantial legal question to resolve, who is (perhaps for that reason) not pressed for decision by the IRS, is denied such relief by the very strength of his case, if it is ultimately decided against him.

(3) Under the Circuit Court view a future Abner Michaud would not dare avail himself of the benefits of Chapter XI of the Bankruptcy Act in an attempt to rehabilitate his business, if he were also contesting a claim of tax deficiency with IRS, because if his attempted Chapter XI arrangement failed and he became a bankrupt, and if the tax deficiency issue went against him, then he would be denied the benefit of a discharge in bankruptcy. His necessary recourse, if properly advised, would be to attempt to settle with his creditors outside the protective umbrella of the Court, and, in all events, take or consent to an assessment before a bankruptcy could be precipitated. An incongruous result indeed for a statute intended as a tool for rehabilitation of debtors! And an even more incongruous result for remedial amendments to that statute intended to provide tax relief for debtors and a more equitable division of assets among creditors!!

In short, the basic purpose of the remedial legislation was to (1) give relief from stale taxes to such a person as the bankrupt-taxpayer here, and (2) to provide his creditors with an equitable share of his assets instead of allowing stale and ancient tax claims to absorb the entire estate. If those twin purposes are ever to be given effect, they should be given effect here.

Conclusion

For the foregoing reason, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Third Circuit.

Respectfully submitted,

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(See Addendum Next Page)

ADDENDUM

Attention is called to the article of Professor Charles Seligson, Chairman of the National Bankruptcy Conference and Member of the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States, entitled "*Some Observations on the 1966 Amendments of Sections 17a and 64a and Decided Cases Thereunder*" at 45 Am. Bankr. L. J. 281, 292-301, and to the context of the quotation from page 300 thereof set forth in footnote 20 of the Opinion of the Court of Appeals at 458 F. 2d 959, page 14a *infra:*

> "It cannot be denied that the language of proviso (c) is not crystal-clear. Read literally, the interpretation placed upon that language by the appellate court in *Indian Lakes* can hardly be challenged. . . . Such a literal construction, however, is unnecessary and defeats the rehabilitative purposes of the amendment to Section 17a. Indeed, it makes proviso (c) meaningless.
>
> "Furthermore, there is no reason why the statute of limitations should run where a taxpayer reports all the necessary facts for the determination of any deficiency and not run for the purposes of proviso (c). These two provisions should be regarded as parallel as suggested by the district court in *Michaud*. A construction of proviso (c) in accordance with the interpretation placed upon the statute of limitations provision of the Internal Revenue Code would carry out the congressional policy not only to give the honest but distressed debtor a new lease on his economic life but also to enable the general creditors to obtain a greater share of the moneys available for distribution."

Appendix A—Opinion of the Court, United States Court of Appeals for the Third Circuit, No. 71-1165 (Filed April 10, 1972)

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 71-1165

In the Matter
of
ABNER MICHAUD and ALYCE E. MICHAUD,
Bankrupts,

UNITED STATES OF AMERICA,
Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA.

Argued January 24, 1972.

Before BIGGS and VAN DUSEN, *Circuit Judges,* and GREEN, *District Judge.*

OPINION OF THE COURT

(Filed April 10, 1972.)

VAN DUSEN, *Circuit Judge.*

The United States has appealed from a district court order[1] which affirmed the order of a referee in bankruptcy denying priority status to the income tax claims of the

[1] *In re Michaud,* 317 F. Supp. 1002 (W. D. Pa. 1970).

Appendix A—Opinion of the Court, United States Court of Appeals for the Third Circuit, No. 71-1165 (Filed April 10, 1972).

United States. The primary issue to be resolved on this appeal is whether the district court was correct in concluding that Section 17a(1)(c) of the Bankruptcy Act, 11 U. S. C. § 35 (a) (1) (c), operates to release Abner Michaud and Alyce E. Michaud from their federal income tax deficiencies for the years 1955, 1956, 1957, 1958 and 1960, with the result that under the terms of Section 64a(4) of the Bankruptcy Act, 11 U. S. C. § 104(a)(4),[2] the United States is not entitled to a priority over general unsecured creditors with respect to these tax deficiencies. We have concluded that the district court was incorrect in its interpretation of Section 17a(1)(c) and reverse the district court order.

Section 17a(1) of the Bankruptcy Act, 11 U. S. C. § 35(a)(1), as amended in 1966, provides, in relevant part, as follows:

> "(a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts . . . except such as (1) are taxes which became legally due and owing by the bankrupt to the United States . . . within three years preceding bankruptcy: *Provided, however,* That a discharge in bankruptcy shall not

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[2] Section 64a(4) of the Bankruptcy Act provides in relevant part as follows:

> "*Debts Which Have Priority*—a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be . . . (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: . . ."

> release a bankrupt from any taxes . . . (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt . . ."

The United States concedes that the taxes at issue (*i.e.*, income taxes of the bankrupts for the years 1955-1958 and 1960) became legally due and owing more than three years preceding bankruptcy[3] (appellant's brief at 10, n. 11); thus, the Government's income tax claims for these years would be released by the Michauds' discharges in bankruptcy[4] under the terms of Section 17a(1), unless the above-quoted subsection (c) preserves them.[5] Further, the trustee (the appellee in this action) concedes that the second condition listed in Section 17a(1)(c) has been satisfied, that is that the taxes at issue were not assessed prior to bankruptcy by reason of a prohibition on assessment pending

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[3] Abner Michaud petitioned for an arrangement under Chapter XI of the Bankruptcy Act on December 2, 1965, and on May 4, 1966, his wife, Alyce E. Michaud, filed a Petition in Bankruptcy. The United States concedes that the taxes here in question were "due and owing" at the due date of the returns for each of the years 1955-1958 and 1960. Appellant's brief at 10, n. 11. *See In re Able Roofing and Sheet Metal Co.*, 425 F. 2d 699 (5th Cir. 1970).

[4] On April 19, 1967, both Abner Michaud and Alyce E. Michaud were granted discharges under the Bankruptcy Act, except as to "such debts as are, by said Act, excepted from the operation of a discharge in bankruptcy" (84a, 85a).

[5] The United States has not argued that any of the other exceptions contained in Section 17a(1) apply to the income tax claims against the Michauds which are involved in this proceeding.

the exhaustion of the bankrupts' administrative and judicial remedies.[6] (appellee's brief at 8). Thus the decision on this appeal turns on whether the first condition listed in subsection (c) has been satisfied, that is, whether the taxes at issue are "taxes . . . which were not reported on a return made by the bankrupt . . ." within the meaning of Section 17a(1)(c) of the Bankruptcy Act.

During the period 1955-1960, Abner Michaud held a 95% interest in a partnership which conducted a meat processing and distributing business. In his tax returns for this period,[7] Michaud claimed as business deductions 3% of the partnership's gross sales, representing payments to the managers, chefs, purchasing agents and other customer representatives with whom the partnership dealt, which payments were characterized as "sales promotion expenses" by the bankrupts and as "kickbacks" by the

[6] On May 6, 1963, the United States sent the Michauds a notice of deficiency pursuant to Section 6213 of the Internal Revenue Code. The Michauds filed timely petitions for redetermination of their liabilities in the United States Tax Court, which proceedings were pending at the times that the Michauds filed their respective petitions under the Bankruptcy Act on December 2, 1965, and May 4, 1966. Under the terms of Section 6213 of the Internal Revenue Code, the pendency of these Tax Court proceedings precluded the assessment of these taxes by the United States, except by jeopardy assessment pursuant to Section 6861.

[7] Partnership returns were filed on behalf of the partnership for its fiscal years ending March 31 of each year in question and the individual joint returns filed by the Michauds on a calendar year basis reflected the income attributable to Abner Michaud's interest in the partnership, as computed on the partnership returns. It appears that Alyce E. Michaud's liability to the United States arises from her signing of the Michauds' joint federal income tax returns during the years at issue.

United States. The United States has conceded that Michaud fully stated his income during this period, that the Internal Revenue Service was aware of the fact that kickbacks were paid to purchasers in the meat processing and distributing industry, and that the amount and character of these "sales promotion expenses" deductions taken by the Michauds were apparent from their returns (see the Referee's opinion at 3-4, 98a-99a). On the other hand, the Referee and the district court have determined that these deductions were properly disallowed by the Government,[8]

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[8] On stipulation of the parties, the Referee determined the substantive issue of whether the United States had properly disallowed the "sales promotion expenses" deductions taken by the Michauds. The Referee found that all of these deductions were properly disallowed because the payments involved were "in violation and frustration of a clearly defined state and federal policy" (100a) and allowed the Government a general claim in the amount of $94,651.73, plus applicable interest to the date of filing of the arrangement petition on December 2, 1965, plus "the amount due for the year 1960 on taxable income not in excess of $44,000.00 and said interest" (98a, 100a and 112a-114a). The district court sustained both the Referee's determination that the kickback payments were in contravention of public policy and the Referee's computation of the amount allowed. 117 F. Supp. at 1009. Since neither the Referee nor the district court has yet determined the exact amount of tax and interest due for the year 1960 (see page 17 of Referee's opinion at 18a), such a determination will apparently be necessary on remand. See *Hugh H. Eby Co. v. United States*, ____ F. 2d ____ (3d Cir. No. 71-1200, Opinion of 3/22/72).

The trustee-appellee has argued before this court that the Referee and district court erred in disallowing the deductions taken by the Michaud partnership on public policy grounds. The trustee, however, did not cross-appeal from the district court's judgment, so that this court cannot upset a portion of the district court's judgment not challenged by the Government's appeal. *See Swarb v. Lennox*, ____ U. S. ____, 40 L. W. 4227, 4230 (No. 70-6, Feb. 24, 1972):

> "In the absence of a cross-appeal, the opposition is in no position to attack those portions of the District Court's judgment that are favorable to the plaintiff-appellants."

(Footnote continued on following page)

so that the income tax *liability* for which the United States claims priority was *not* stated in the returns filed by the Michauds.[9]

The Referee and the district court held that in these circumstances the taxes at issue were not "taxes . . . which were not reported on a return made by the bankrupt" within the meaning of Section 17a(1)(c) of the Bankruptcy Act, so that these tax claims of the United States were released by the discharge in bankruptcy and were, therefore, not entitled to priority under the terms of Section 64a (4) of the Act. Noting that a fundamental purpose of the 1966 amendments to the Bankruptcy Act was to provide for the effective rehabilitation of the bankrupt by providing some time limit on the tax claims exempt from release after a discharge in bankruptcy,[10] the district court concluded that this purpose would be substantially frustrated

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(Footnote continued from preceding page)
See also Jamesbury Corp. v. Worcester Valve Co., 443 F. 2d 205, 208 n. 3 (1st Cir. 1971); *United Stores of America, Inc. v. Fireman's Fund Ins. Co.*, 420 F. 2d 337, 340 (8th Cir. 1970). We note also that the district court sustained the Referee's finding that the bankrupts failed to properly substantiate the major portion of the kickback payments, so that notwithstanding public policy considerations, the Michauds' income tax deficiency for the years 1955-1958 was found to be $72,500.00, plus interest (see 113a, 317 F. Supp. at 1009).

[9] The tax claims for which the United States asserts priority are based upon deficiencies which were computed by subtracting the amount of the tax shown on the Michauds' returns from the tax liabilities determined by the Referee on the basis of the record, including stipulations, to be due. See footnote 8, *supra*.

[10] Prior to the passage of the 1966 amendments to the Bankruptcy Act, a discharge in bankruptcy did not release the bankrupt from his federal, state, or local tax liabilities. See 11 U. S. C. § 35 (1964).

if the Government's tax claim were not released in the circumstances of this case.[11] The district court further declared that Section 17a(1)(c) of the Bankruptcy Act and the three-year statute of limitations on assessments in Section 6501 of the Internal Revenue Code (26 U. S. C. § 6501) are in *pari materia* and appeared to reason that because the latter operates normally to preclude the Government from making an assessment more than three years after the return is filed if the taxpayer has included his full gross income on his return,[12] the former should be construed similarily so as to discharge a tax claim which arose more than three years before a discharge in bankruptcy, provided that—as is concededly the case with the Michauds—the bankrupt has stated his full gross income and indicated the nature of his unwarranted deduction in his return.

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[11] See footnote 17, *infra*.

[12] Under Section 6501(e)(1) of the Internal Revenue Code, the three-year statute of limitations prescribed in Section 6501(a) applies unless the taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return," in which case assessment or collection procedures may be begun within six years after the filing of the return. Thus, if the taxpayer fully reports his income in his return but takes a deduction to which he is not entitled, the three-year limitations period applies; but if the same taxpayer omits from his return more than 25% of the gross income stated in the return, the six-year limitation applies. (Exceptions to this rule are made in the cases of a fraudulent return, a willful attempt to evade tax, and a failure to file a return, in which case assessment or collection may be begun at any time pursuant to Section 6501(c) of the Internal Revenue Code. Analogous exceptions are contained in Section 17a(1) of the Bankruptcy Act, 11 U. S. C. § 35(a)(1).)

Appendix A—Opinion of the Court, United States Court of Appeals for the Third Circuit, No. 71-1165 (Filed April 10, 1972).

We reject this conclusion reached by the district court and conclude that the phrase "taxes . . . which were not reported on a return made by the bankrupt" as used in Section 17a(1)(c) of the Bankruptcy Act includes a tax deficiency ultimately established by the Government even if, as in the case of the Michauds, the taxpayer has fully reported both his gross income and the basis of the deductions which are ultimately disallowed. Although the matter is not free from doubt in view of the scant legislative history,[13] we believe that this interpretation of Section 17a(1)(c) is the most reasonable construction of the language used by Congress and that the result which we reach is consistent with the purposes of this 1966 amendment to the Bankruptcy Act. The critical factor is that in Section 17a(1)(c) Congress has excepted from the general rule of Section 17a(1) "taxes . . . which were *not reported* on a return made by the bankrupt." (Emphasis added.) As the Supreme Court has indicated many times, "normally 'statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them.'" *Colony, Inc. v. Comm'r*, 357 U. S. 28,

[13] In *In re Indian Lake Estates, Inc.*, 428 F. 2d 319, 320 (5th Cir. 1970), the Fifth Circuit, in the only Circuit Court opinion construing Section 17a(1)(c) to which we have been referred, commented on its task as follows:

> "This mortal court must attempt to divine the intent of Congress in a situation where that intent may well be known only to the Divine. We must say what Congress meant by two brief phrases in a technical proviso passage of an amendment to the dischargeable debt provisions of the bankruptcy laws when an exhaustive examination by counsel for both parties and this Court of the history of the legislative processes leading to this enactment fails to disclose that the meaning or the significance of the language critical to our decision, was ever really considered."

32 (1958). See also *Banks v. Chicago Grain Trimmers*, 390 U. S. 459, 465 (1968) ("In the absence of presuasive reasons to the contrary, we attribute to the words of a statute their ordinary meaning . . ."). The verb "report" is defined in Webster's New International Dictionary (3d ed. 1961) as follows: "to give a formal or official account or statement of: state formally." "Report," in other words, connotes the *formal* representation of a state of facts rather than the informal presentation which would be connoted by the terms "indicate," "include," etc. The fact that Congress employed the term "reported" in Section 17a(1)(c) demonstrates, therefore, that Congress intended to make the critical factor whether the taxes at issue were formally stated in the return.[14] Since it is conceded by the trustee that the tax liabilities at issue in this case were not stated on the Michauds' returns, it follows that under the terms of Section 17a(1)(c) these tax claims were not released by the Michauds' discharge in bankruptcy. There is no basis in this language for the distinction suggested by the district court between a tax liability which is not reported on the return because gross income has been understated and a tax liability which is not stated in the return because an unwarranted deduction has been taken. When Congress has intended to make such a distinction it has done so clearly, as in the case of the statute of limitations on the assessment and collection of income tax claims in Section

[14] This interpretation of Section 17a(1)(c) is strengthened by the fact that Section 17a(1)(c) is phrased in terms of "taxes . . . which were not reported *on* a return made by the bankrupt," (emphasis added). See also the discussion of *Colony, Inc. v. Comm'r*, 357 U. S. 28 (1958), in footnote 15, *infra*.

6501 of the Internal Revenue Code.[15] No such distinction has been made in Section 17a(1) of the Bankruptcy Act.[16]

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[15] See footnote 12, *supra*. We cannot agree with the district court that the three-year statute of limitations on assessments in Section 6501 of the Internal Revenue Code and the three-year period for non-dischargeable tax liabilities in Section 17a(1) of the Bankruptcy Act are in *pari materia*, since the language used in the two sections is so substantially different. Similarly, we do not find the cases construing language in Section 6501(a)—*Germantown Trust Co. v. Comm'r*, 309 U. S. 304 (1940) (construction of the term "return" in the predecessor to Section 6501(a))—or in Section 6501(e)—*Colony, Inc. v. Comm'r*, 357 U. S. 28 (1958); *Davis v. Hightower*, 230 F. 2d 549 (5th Cir. 1956); *Deakman-Wells Co. v. Comm'r*, 213 F. 2d 894 (3d Cir. 1954); *Uptegrove Lumber Co. v. Comm'r*, 204 F. 2d 570 (3d Cir. 1953)—support the district court's interpretation of the substantially different language in Section 17a(1)(c). We believe these cases, if anything, strengthen the interpretation which we give to Section 17a(1)(c). For example, in *Colony, Inc. v. Comm'r, supra*, the Court held that the phrase "omits from gross income an amount properly includible therein" in the predecessor to Section 6501(e) did not include an understatement of gross income resulting from a taxpayer's miscalculation of profits through the erroneous inclusion on the return of an excessive item of cost. The Court laid stress on the fact that the term "omit" was defined in Webster's New International Dictionary (2d ed. 1939) as "To leave out or unmentioned; not to insert, include or name," whereas the source of the error for which the Government asserted a tax deficiency was disclosed on the face of the return. 357 U. S. at 32-33, 36. In the 1966 amendments to Section 17a of the Bankruptcy Act, however, Congress did not use the phrase "taxes . . . which were *omitted* from a return," which at least arguably under the *Colony, Inc.* decision would not have included the case where the taxpayer has indicated on the face of his return the basis of a subsequently disallowed deduction. Instead, Congress used the phrase "taxes . . . which were not *reported on* a return," which language, as indicated above, focuses attention on the formal indication of the tax liability in the bankrupt's tax return. See pages 8-9, *supra*.

[16] We do not mean to imply that Congress has been crystal clear in drafting Section 17a(1)(c). The interpretation which we place on this language might have been clearer if, for example, Congress had provided that a discharge in bankruptcy shall not release a bankrupt from any taxes "(c) which do not appear designated as such on a return made by the bankrupt. . . ."

Appendix A—Opinion of the Court, United States Court of Appeals for the Third Circuit, No. 71-1165 (Filed April 10, 1972).

The construction which we give to Section 17a(1)(c) is not inconsistent with the intent of Congress in drafting the 1966 amendments to the Bankruptcy Act. As the district court noted, Congress clearly intended to stimulate the successful rehabilitation of the bankrupt by means of the release after bankruptcy of older tax liabilities. Although the district court assumed that its construction of Section 17a(1)(c) was most consistent with this purpose, it is not clear that this assumption is correct, at least in the long run.[17] Furthermore as the exceptions to Section 17a(1)

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[17] The district court emphasized that under the construction which we give to Section 17a(1)(c) a taxpayer who elects to pursue his administrative or judicial remedies to dispute the Government's disallowance of a deduction claimed in his return faces a risk that his tax liability for the period involved may not be released by a subsequent discharge in bankruptcy. See 317 F. Supp. at 1006-07. This risk arises because Section 17a(1)(c) excepts from the general release rule taxes which were not assessed prior to bankruptcy because of a prohibition on assessment pending the exhaustion of the bankrupt's administrative and judicial remedies. Thus, if a taxpayer chooses to contest the Government's tax claim within the three-year period specified in Section 17a(1)(c) by proceedings which suspend the Government's authority to assess the tax, and if these proceedings have not terminated prior to the taxpayer's bankruptcy, then the Government's tax claim is not released by the taxpayer's discharge in bankruptcy no matter how long after the taxes became due and owing the bankruptcy took place.

The construction of Section 17a(1)(c) adopted by the district court, however, could lead to an even more difficult situation for the taxpayer because of the authority granted to the Secretary of the Treasury in Section 6861 of the Internal Revenue Code. Section 6861(a) provides as follows:

> "If the Secretary or his delegate believes that the assessment or collection of a deficiency . . . will be jeopardized by delay, he shall, notwithstanding the provisions of section 6213(a), immediately assess such deficiency (together with all interest, additional

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themselves indicate, Congress attempted to balance against the bankrupt's interest the interests of the federal state and local governments in the collection of tax revenues to

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amounts, and additions to the tax provided for by law), and notice and demand shall be made by the Secretary or his delegate for the payment thereof."

Thus, if the Secretary believes that the collection of federal taxes will be jeopardized by the taxpayer's exhaustion of administrative or judicial remedies before normal assessment maye be made (as, for example, in those cases where the taxpayer's bankruptcy is likely), he may feel required to make a jeopardy assessment within three years after the taxes were due and owing to avoid a release pursuant to Section 17a(1)(c). *See* Plumb, "Federal Tax Liens and Priorities—Agenda for the Next Decade," 77 Yale L. J. 228, 266 (1967). This procedure can assure the Government of priority in the bankruptcy proceeding, even under the interpretation of Section 17a(1)(c) advanced by the district court, because Section 17a(1) specifically provides that "a discharge in bankruptcy shall not release or affect any tax lien," and under the terms of Sections 6861(a), 6321 and 6322 of the Internal Revenue Code a jeopardy assessment creates a tax lien against the taxpayer's property, which, if properly recorded pursuant to Section 6323, is valid as against the trustee in bankruptcy. See *United States v. Speers*, 382 U. S. 266 (1965). (Several courts have held, however, that such a tax lien is not effective as to assets acquired after bankruptcy. *See e. g., In re Braund*, 423 F. 2d 718 (9th Cir. 1970).) The use of this jeopardy procedure by the Government, however, may seriously jeopardize the taxpayer's ability to obtain both secured and unsecured credit, since future lenders would be on notice of the Government's prior lien on all of the taxpayer's property. Thus, certain taxpayers may find themselves unable to secure needed credit because of a tax lien based upon a tax claim that may prove to be partially or wholly unwarranted. The result may be the failure and bankruptcy of taxpayers who could have survived if credit had been available. *Cf.* Plumb, *supra*, at 268; *but cf.* Seligson, "Some Observations on the 1966 Amendments of Sections 17a and 64a and Decided Cases Thereunder," 45 Am. Bankr. L. J. 281, 299 (1971).

meet their myriad responsibilities.[18] The plain meaning of the language employed by Congress in Section 17a(1)(c) indicates that this latter interest was intended to prevail in the circumstances presented by this appeal. If this exception is thought too broad in light of the remedial purposes of the 1966 amendments to the Bankruptcy Act, it is Congress, not the courts, which must amend the statute.

Finally, we note that the result which we reach is supported by the only other cases construing Section 17a(1)(c) to which we have been referred. See *In re Indian Lake Estates, Inc.*, 428 F. 2d 319 (5th Cir. 1970);[19] *In re Cohen*,

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[18] See *In re Indian Lake Estates, Inc.*, 428 F. 2d 319, 323 (5th Cir. 1970), where the court observed:

"Obviously, the damage to the public purse was the balancing policy consideration."

A loss to the Government occurs not only because of the discharge provision in Section 17a(1) but also because of the priorities set forth in Section 64a(4) of the Bankruptcy Act (see note 2, *supra*). Although several commentators have suggested that the tie-in is unwise, see, *e. g.*, Plumb, *supra*, note 17, at 268, Section 64a(4) grants priority status only to those tax claims which are not released by a discharge in bankruptcy. Thus, if a tax claim is released pursuant to Section 17a(1), the Government loses not only its right to proceed against the taxpayer after his discharge in bankruptcy but also its claim in the bankruptcy proceedings of priority over general unsecured creditors.

[19] The district court suggested that this decision of the Fifth Circuit was distinguishable since "[t]he court in *Indian Lakes Estates* was dealing with a corporate debtor where the dischargeability feature was meaningless and only the decision on priority had any practical effect." 317 F. Supp. at 1005. However, there is nothing in the language of Section 17a(1)(c) to suggest that Congress intended different rules to apply to individual and corporate bankrupts. See Sections 1(4) and 1(23) of the Bankruptcy Act, 11 U. S. C. §§ 1(4) and 1(23).

21 A. F. T. R. 2d 992 (N. D. Ga. Nov. 3, 1967). Our interpretation is also supported by several leading authorities. See 1 Collier, Bankruptcy § 17.14(4), at 1620 (14th ed. 1967); Plumb, "Federal Liens and Priorities—Agenda for the Next Decade," 77 Yale L. J. 228, 263 (1967); *cf.* Kennedy, "The Bankruptcy Amendments of 1966," 1 Ga. L. Rev. 149, 177 (1967).[20]

For the foregoing reasons, the decision of the district court will be reversed and the case remanded for proceedings consistent with this opinion.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Third Circuit.

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[20] *But see* Seligson, "Some Observations on the 1966 Amendments of Sections 17a and 64a and Decided Cases Thereunder," 45 Am. Bankr. L. J. 281, 292-301 (1971). Even Professor Seligson, however, concedes that "[r]ead literally, the interpretation placed upon that language [of Section 17a(1)(c)] by the appellate court in *Indian Lakes* can hardly be challenged." 45 Am. Bankr. L. J. at 300.

Appendix B—Opinion of Weber, J., Dated October 1, 1970

IN THE
UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

In the Matter
of
ABNER MICHAUD and ALYCE MICHAUD
Bankrupts

No. 65-126 Erie
in Bankruptcy.
(Consolidated Cases.)

OPINION.

WEBER, *J.* October 1, 1970.

This matter comes before the court on the Petition of the United States for Review of the Order of the Hon. William B. Washabaugh, Jr., Referee in Bankruptcy, entered October 10, 1969 granting a discharge to the Bankrupt and thereby denying priority treatment to certain claims of the United States for income taxes. Other matters raised by the Petition for Review are largely dependent upon the determination of the dischargeability issue.

For over 20 years the Bankrupt[1] conducted a meat processing and distributing business and filed income tax

[1] The term "bankrupt" used herein refers to both Mr. and Mrs. Michaud. There are actually two bankrupts and two cases. Abner Michaud and Alyce Michaud are husband and wife who filed separate bankruptcy petitions. They filed joint individual income tax returns. The claimed tax deficiency here involved arose from disputed business expense deductions on a partnership income tax return of husband's business.

returns showing all gross income and claiming as a business deduction 3% of gross sales as a "sales promotion expense" represented by payments to managers, chefs, purchasing agents and other customer representatives, all generally known as "kickbacks". These returns were examined annually, the deduction was not questioned by the Internal Revenue Service, and the practice was known by the I. R. S. as almost universal throughout the industry. In 1958 the I. R. S. instituted a policy of questioning these deductions and checked the returns of persons engaged in this business on a nationwide scale.

The deductions were disallowed and then a formula was adopted for compromising the disallowed "kickback" deductions; 50% of the claimed deduction would be allowed where the payments were "substantiated" (*i.e.* where the recipient of the payment was identified), and 25% would be allowed where the payment was "unsubstantiated" (*i.e.* on insufficient proof of payment but no identification of the recipient). An obvious purpose of the I. R .S. policy was to enforce income tax reporting by recipients. As a result of the 1958 policy, Bankrupt's returns were audited and the claimed deductions were disallowed for the years 1955, 1956 and 1957. A notice of proposed deficiency (the 90 day letter) was sent, the taxpayer petitioned the Tax Court within this time, thus preventing the assessment of the deficiency within the three years prior to the bankruptcy, a condition imposed by Sec. 17a(1) (c) of the Bankruptcy Act for denial of discharge. The case was at issue and never tried before the filing of the bankruptcy petition.

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

It may be noted that for the years in question the business was conducted as a partnership, with Bankrupt owing a 95% interest, and the claimed deductions were reported on the partnership income tax return. Bankrupt reported all income from the partnership on his individual tax return.

The 1966 amendments to the Bankruptcy Act in Sec. 17a(1) 11 U. S. C. 35a(1) made taxes dischargeable which became legally due and owing more than 3 years preceding the bankruptcy, except those taxes . . .

> "(c) which were not reported on a return made by the bankrupt(s) and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhausting of administrative or judicial remedies. . . ."

No assessment of the deficiency was made in this case within 3 years prior to bankruptcy because administrative and judicial remedies were pending. Despite the possibility of a jeopardy assessment, we will consider the second requirement of Sec. 17a(1)(c) as met.

Our problem is whether the taxes in question were "taxes . . . which were not reported on a return made by the bankrupt", when the gross income of the bankrupt was reported and the basis and amount of the claimed business expense deductions was fully set forth, and the resultant taxable income after taking such deductions was correctly computed, but when the Commissioner disallowed certain claimed business expense deductions and sent the taxpayers a 90 days notice of a proposed deficiency the determination of which was still pending at the time of the filing of the bankruptcy petition.

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

There is an extreme scarcity of judicial interpretation of the meaning of the provisions "taxes . . . not reported on a return". Only one case has dealt with the problem in a factual context similar to this case, a decision which was issued subsequent to the Memorandum and Order of the Referee in the present case: *Indian Lakes Estates, Inc. v. Stewart, Trustee,* 428 F. 2d 319 [5th Cir., 1970].

There the Court faced the same problem as here:

> "We are not presented with a situation where the taxpayer filed a fraudulent or evasive return. It appears that the reason for the assessment arose because of a difference of opinion in the resultant tax liability properly attributable to a non-fraudulent return. It is obvious that the assessment was for the difference between the amount shown by the taxpayer on its return and the amount calculated as correct by the Director." (p. 324)

and also

> "No issue is presented as to any failure to file a return or as to filing of a false or fraudulent return or as to any attempt to evade or defeat taxes. The taxes here involved were not collected or withheld from others." (p. 322)

The Court of Appeals for the Fifth Circuit had a difficult time with the question. It sought guidance from the legislative history as to the meaning of the specific phraseology.

> "From all we have been able to discover, the specific proviso which controls the case at bar just never received direct public congressional attention of explication." (p. 323)

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

However, the court did find that the Senate Committee on the Judiciary declared the fundamental policy of the Bankruptcy Act to be twofold: (1) the effective rehabilitation of the bankrupt, and (2) the equitable distribution of the bankrupt's assets among the creditors, citing Sen. Report 1158, 89th Congress, 2nd Sess. [1966].

The Court then considered that,

> "Effective rehabilitation was pointedly intended to provide relief for individual bankrupts. (emphasis by the court). A contrast was drawn between corporate bankrupts who carried no practical burden even when saddled with enormous after-bankruptcy tax liabilities, since their artificial entity could be dissolved. Natural persons, on the other hand, who went into bankruptcy with large tax debts remained burdened with such debts and their intended and desired rehabilitation was inadequitable hindered." (p. 322)

The court in *Indian Lakes Estates* was dealing with a corporate debtor where the dischargeability feature was meaningless and only the decision on priority had any practical effect.

In *Indian Lakes Estates* the court cited the only judicial interpretation of the 1966 Bankruptcy Act amendments available, *In re Cohen,* 21 AFTR 2d 992 [1967], a decision of the referee in bankruptcy for the Northern District of Georgia. Cohen was different on its facts and represented a peculiar situation. While hard cases are blamed for making bad law, easy cases set difficult precedents. In *Cohen* a voluntary petition was filed February 13, 1967. It listed no debts, secured or unsecured, other than taxes due the United States for the year 1958, the determination

of which were then pending in the United States Tax Court. Upon the filing of the bankruptcy petition the usual order of temporary restraint was issued. It required creditors holding claims which they contended would not be discharged by the bankruptcy and upon which they wished to pursue further remedies of collection to file application to the bankruptcy court. The United States made such application on April 11, 1967, reciting that the bankrupt had filed his petition in the United States Tax Court on March 25, 1965, asking for a redetermination of the deficiency proposed by the I. R. S. and that the Tax Court had decided the question of liability in favor of the United States on March 25, 1967. It is interesting to note that the decision of the Tax Court was made pursuant to a stipulation entered into between bankrupt and the I. R. S. in which the full amount of the proposed deficiency was conceded. From this we assume that the bankrupt was aware of the eventual determination of his liability at the time of filing his bankruptcy petition. Thus having secured a determination in the Tax Court free of any showing of fraud, and arguing that discharges are favored by the bankruptcy law to relieve unfortunate debtors, he sought relief from this tax obligation through the voluntary bankruptcy proceeding. While ordinarily this defense would be one properly raised in the proceedings employed to enforce the particular liability, for reasons of convenience and efficient judicial administration, and by the prayer of both parties for determination, the bankruptcy court undertook to determine the dischargeability of this particular and only obligation of the bankrupt. The opinion of the referee recites the evidence before the Tax Court showing

large items of gross income not disclosed on the return and the referee found as a fact that the taxes claimed by the I. R. S. in its notice of deficiency were not reported on a return made by the bankrupt, the exact condition which the statute prescribes. Under any interpretations of Sec. 17(a)(1)(c) the exception must apply. The referee's further conclusion that "taxes" mean tax liability is dictum and not necessary to his disposition of the case. Actually, the referee's dictum was addressed to the bankrupt's defense that he had reported all tax information to his tax consultant who had prepared the return, a defense which the referee characterized as "untenable". While the referee's opinion does not refer to it, there is a suggestion from the entire record of the case as recited by the referee that if the issue were pressed by the government, tax liability might not be dischargeable under Sec. 17a(1)(d), as a wilful attempt to evade.

Under the analogy between the three year statute of the Internal Revenue Code, 26 U. S. C. 6501(a) and (e), and the parallel three year limitation for tax liability in Sec. 17a(1) of the Bankruptcy Act, 11 U. S. C. 35(a), recited by Senator Ervin (Report of Senate Judiciary Committee, No. 1158, p. 3), if tax liability is not disclosed by inclusion of income in the return there is no bar of the statute of limitations under the Internal Revenue Code and there should be consequently no discharge in bankruptcy. *Cohen* was a voluntary petition. There being no other creditors there was no problem of equitable distribution of assets. Upon disallowance of the discharge by the referee the bankrupt moved to dismiss his petition in bankruptcy, to which the Internal Revenue Service had no objection.

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

Therefore neither *Indian Lake Estates* nor *Cohen* present a fundamental conflict with the paramount policy of the Bankruptcy Act, the effective rehabilitation of the bankrupt and the equitable distribution of the assets.

We have recited the parallel provisions of the 3 year statutes of limitations of the Internal Revenue Code. There is a wealth of judicial construction on Sec. 6501 of the Internal Revenue Code to the effect that full disclosure of the liabilities in question on the return is sufficient to keep them within the statute of limitations notwithstanding that the tax computation is on another basis than the determination of the government. *Colony, Inc. v. Commr.* 357 U. S. 28 [1958]; *Davis v. Hightower,* 230 F. 2d 549 [5th Cir. 1956]; *Deakman-Wells Co. Inc. v. C. I. R.,* 213 F. 2d 894 [3rd Cir., 1954]; *Uptegrove Lumber Co. v. C. I. R.,* 204 F. 2d 570 [3rd Cir., 1953] all recite the manifest purpose of Congress to limit the government to those cases where the taxpayer failed to include the income under the gross income on his return.

The facts upon which tax liability was computed by the bankrupt in this case was disclosed in the bankrupt's informational partnership return. His own individual return correctly stated the income from his partnership interest. In *Germantown Trust Co. v. Commr.,* 309 U. S. 304 [1940] where the government contended that there was no bar of the statute of limitations because no corporation return was filed (Form 1120) as required for the investment trust operation which the taxpayer conducted, the taxpayer showed that it had filed a fiduciary return (Form 1041) disclosing all the income of the trust and the names of the

parties to whom the distributive shares of income had been paid. The Court rejected the government's argument:

> "It cannot be said that the petitioner, whether treated as a corporation or not, made no return of the tax imposed by the statute. Its return may have been incomplete in that it failed to compute a tax, but this defect falls short of rendering no return whatsoever." (p. 310)

Another aspect of the government's contention impresses us. The entire remedial effect of the 1966 Amendment to the Act can be nullified in any case where there is a difference of opinion between the I. R. S. and the taxpayer over the claimed deductions. Wherever the taxpayer elects to pursue his administrative or judicial remedies the three year statutory period prior to bankruptcy can never start to run unless the taxpayer withdraws his objections to the government's proposed determination and agrees to the tax liabilities in the manner computed by the government so that an assessment could be made.

To give this practical application it means that a taxpayer can only disagree with the I. R. S. under the very likely unforeseen penalty of refusal of a discharge in bankruptcy if the dispute is unresolved by administrative or judicial remedies pending three years prior to his petition in bankruptcy. In the parlance of the gambling fraternity I believe that such a practice is generally described as "sandbagging", which Webster more politely described as "to coerce by crude means". (Webster's Seventh New Collegiate Dictionary.)

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

The rationale of the Internal Revenue Code statute of limitations cases is applicable here:

> "The only way in which the taxpayer here could satisfy the government's requirement that he state his 'gross income' in a way to permit a tax computation of the amount the government claims is due, would be for him to abandon his claim that he was entitled to capital gains treatment of the sales in question. No such penalty was intended by Congress in extending the statutory period to 5 years in the case of substantial omission."
>
> *Davis v. Hightower*, cit. *supra*, p. 553; and
>
> "For there are many places throughout an income tax return where a taxpayer may make arithmetical errors or claim improper deductions with the result that his tax liability is understated. If such errors are made in good faith at any place other than the gross income section, it is clear that the government must challenge them, if at all, within the normal three year limitation period."
>
> *Uptegrove Lumber Co. v. C. I. R.*, cit. *supra*, p. 573.

Indian Lakes Estates, supra, also found support in 1 Collier on Bankruptcy, 14th ed., Sec. 17.14 (4), p. 1620, where we find the following:

> "First of all, the exception (Sec. 17a (1) (c)) relates to taxes due more than three years before bankruptcy 'which were not reported on a return'. This language *should* mean where the tax liability was not reported as distinguished from the information giving rise to the liability." (emphasis supplied).

Collier cites no authority and gives no argument to support this construction, but then goes on to note that "The exception in (c) is not as clear as possible.", (p. 1621)

then proceeding to discuss at length the second proviso of sub-section (c) relating to the time of assessment. Collier seems to take the position that anything which bars the government from obtaining its permanent non-dischargeable lien prior to the three year period prior to bankruptcy makes the tax obligation non-dischargeable.

A reference was made in *Indian Lakes Estates, supra,* to the article of William T. Plumb, Jr., "Federal Tax Liens and Priorities in Bankruptcy—Recent Developments" in Journal of the National Conference of Referees in Bankruptcy, Vol. 43, No. 2, p. 44, where footnote 110 states:

> "It is immaterial that full disclosure of relevant information is made in the return, if the amount of *tax liability* (emphasis in original) is understated."

Plumb cites *In re Cohen, supra,* for this statement, although Cohen was a case of failure to disclose income. The only text writer who rises to the status of a prophet is Frank R. Kennedy in "The Bankruptcy Amendments of 1966", 1 Georgia Law Review 149, who correctly guesses:

> "Counsel for the Government undoubtedly will view the taking of an improper deduction on a duly filed income tax return as well as the failure to include any taxable income as an instance of an unreported tax." (p. 177)

We find the government's contention to be in direct opposition to the manifest purpose of the Bankruptcy Act. This was apparent to the Court of Appeals in *Indian Lakes Estates, supra:*

> "We are well aware that this construction does not accord with every broad intention announced by the Congress." (p. 324)

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

But the court there was dealing with a corporate bankrupt where the only practical problem was an equitable distribution of assets rather than the rehabilitation of the debtor. The court was not required to consider the remedial purposes of the statute.

Statutes which are intended to be remedial in nature should be liberally construed. *Sablowsky v. United States*, 101 F. 2d 183 [3rd Cir., 1938). Exceptions to a statute which is remedial in purpose must be strictly construed. *Korberr v. Bumb*, 262 F. 2d 157 [9th Cir., 1958].

We come to the following conclusions:

(1) The fundamental policy of the Bankruptcy Act was aimed at the effective rehabilitation of individual bankrupts.

(2) Statutory provisions regulating discharges are remedial in their nature. They should be construed liberally with the purpose of carrying into effect their legislative intent. 1 Collier on Bankruptcy 1262.

(3) The meaning of the statutory provision is doubtful and this entitles the court to consider the fundamental policy of the statute.

(4) Discharge from liability is an essential element of effective rehabilitation for individual bankrupts. It is meaningless for corporate bankrupts.

(5) The three year statute of limitations on assessments in the Internal Revenue Code and the three year period for non-dischargeable tax liabilities in the Bankruptcy Act are in *pari materia* and their meaning should be given a uniform construction.

(6) The cases construing the statute of limitations under the Internal Revenue Code uniformly sustain the bar of the statute when the taxpayer has disclosed fully on his return the information from which the tax liability can be determined.

(7) The bankrupt filed a tax return in which all of his gross income was disclosed and the nature and amount of his claimed deductions were specified.

(8) The denial of a discharge to the bankrupt in this case is contrary to the fundamental purposes of the Bankruptcy Act and contrary to the legislative intent of the remedial provisions limiting tax liability.

(9) The bankrupt did not fail to report taxes on a return under the provisions of Sec. 17 a (1) (c) of the Bankruptcy Act.

THE AFTER-ACQUIRED PROPERTY ISSUE

The Government objects to Order No. 3 of the Referee discharging bankrupts "from any and every liability in respect to said taxes and interest and penalties thereon.", by attacking the jurisdiction of the Referee to preclude additional recovery against after-acquired property. The question need not be decided here in view of our determination that liabilities for the taxes are discharged. However, the question has been decided by a number of district courts and affirmed by courts of appeal that liens which arose from taxes which are discharged in bankruptcy under Sec. 17(a) as amended in 1966 remain effective only upon assets existing as of the date of the bankruptcy.

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

United States v. Sanabria, 424 F. 2d 1121 [7th Cir. 1970] affirming United States District Court, N. D. Ill. E. Div.;

In re Braund, 423 F. 2d 718 [9th Cir. 1970] affirming 289 F. Supp. 604 [C. D. Cal. 1969];

In re Carlson, 423 F. 2d 714 [9th Cir. 1970] affirming 292 F. Supp. 778 [C. D. Cal. 1969].

See also Kennedy, Op. cit. *supra,* p. 179, and Plumb, Op. cit. *supra,* pp. 44, 45.

We also note from the district courts' reported opinions in *In re Carlson* and *In re Braund* that the matters arose in both cases from proceedings before referees in bankruptcy.

The identical objection to jurisdiction was raised in *In re Braund* before the district court. The district court found jurisdiction under *Local Loan Co. v. Hunt,* 292 U. S. 234, [1934] where it was held that the exercise of such jurisdiction is necessary to achieve the essential purpose of the Bankruptcy Act, a fresh start. See also Kennedy, Op. cit. *supra,* p. 179.

The rationale of all of the above cited cases is that statutes must be construed to carry out their legislative purpose and that it is plain that in amending Sec. 17 of the Bankruptcy Act the purpose of Congress was to enhance the individuals opportunity to financially rehabilitate himself in bankruptcy, by eliminating his old tax debts.

Appendix B—Opinion of Weber, J., Dated October 1, 1970.

THE DETERMINATION OF TAX LIABILITY

By stipulation of the parties the Referee was to determine the substantive tax question in this case arising from the I. R. S. disallowance of the "kick-back" deductions. The Referee decided this issue in favor of the government. The record supports the Referee's findings. The bankrupt failed to produce such evidence as would satisfy the requirement of substantiation of the major portion of these payments, either from his own business records, or corroborating evidence of the identity of the recipients.

As to those payments for which evidence of substantiation was presented, the bankrupt failed to carry his burden of proof as to the knowledge of the employers of the recipients, or custom of the industry, as was shown in *Conway Import Co. v. United States,* 311 F. Supp. 5, [E. D. N. Y. 1969]. Therefore, the Referee's determination that such payments were in contravention of public policy is supported by the record in this case.

COMPUTATION

The Referee allowed the claim of the United States in the sum of $94,652.73 plus applicable interest to the filing date of the Arrangement petition and the amount due for the year 1960 on taxable income not in excess of $44,000 and said interest. This was allowed as a general claim. The Government now disputes this amount and claims $97,172.26 plus interest. The principal difference is largely based upon the Referee's determination that no "restricted interest" was due for the 1958-1961 period under the provisions of Sec. 6611(f) of the I. R. C. The Referee's computation of the amount was pursuant to the Government's Exhibit A and the testimony and stipulation in the record.

We cannot find the Referee's determination clearly erroneous. The counsel for the Government recognizing that there was approximately $75,000 available for distribution, far less than the Government's claim, did not press this point of argument.

ORDER

AND NOW, October 1, 1970, after consideration of the Petition for Review in the within cases, it is

ORDERED that the Referee's Order of October 10, 1969, as thereafter amended, is hereby AFFIRMED for the reasons stated in the foregoing Opinion.

GERALD J. WEBER,
United States District Judge.

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Hon. William B. Washabaugh, Jr.,
Referee in Bankruptcy,
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Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969)

In the Matter of: Abner Michaud and Alice E. Michaud, Bankrupt. U. S. District Court, W. Dist. of Pa., No. 65-126 Erie, Oct. 10, 1969. Years 1955-1960. Decision against Govt.

1. BUSINESS EXPENSES—Expenditures against public policy—questionable, unethical or unlawful businesss expenditures—kickback, split fees, and other expenditures. Business expense deduction denied taxpayer for payments in nature of kickbacks made to customers of his meat purchasing business: payments were in violation of state and federal public policy. He didn't identify recipients or prove that payments were universal custom in his business and were made with consent of recipients' employers. *Reference:* 1969 P-H Fed. ¶ 11,266(10).

2. JEOPARDY, BANKRUPTCY AND RECEIVERSHIP—Bankruptcy and receivership—tax claims in bankruptcy proceedings—priority under Sec. 64, Bankruptcy Act. Bankrupts' tax liabilities were released by discharge in bankruptcy. Income receipts were fully accounted for in their returns for periods of more than 4 years prior to filing of bankruptcy petition. U. S. was entitled to general, not priority claim. *Reference:* 1969 P-H Fed. ¶ 37,696.

George P. Walker, Robert M. Taylor, Philadelphia, Pa., Warren W. Bentz, 404 Marine Bk. Bldg., Erie, Pa., Attys. for Bankrupts.

John V. Bowser, Pittsburgh, Pa., Atty., *pro se* for Receiver & Trustee.

Mitchell Rogovin, Asst. Atty. Gen., Fred B. Ugast, Chief of Gen. Litigation Sec., Louis J. Lombardo, Atty., Tax

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

Div., Dept. of Justice, Wash., D. C., Gary L. Stansbery, Reg. Counsel, U. S. Treasury Dept., Thomas A. Daley, Asst. U. S. Atty., Pittsburgh, Pa., for U. S.

Memorandum and Order on Objections to
Priority Claim of the
Internal Revenue Service

Findings of Fact and Conclusions of Law

WASHABAUGH, Referee:

The bankrupts, Abner Michaud and Alyce E. Michaud, his wife, were discharged from their debts and liabilities by Order of the Referee dated April 17, 1967 in the within consolidated bankruptcy proceedings instituted in respect to the husband by a petition for an Arrangement under Chapter XI of the Bankruptcy Act filed December 2, 1965 in which he was adjudicated a bankrupt on his consent thereto and withdrawal of the Arrangement proceeding October 4, 1966, and in respect to the wife by a petition in voluntary bankruptcy on which she was automatically adjudicated on the filing date of May 4, 1966.

The matter is before the Referee on objections of the trustee and bankrupts to the priority claim of the United States Internal Revenue Service for alleged income tax deficiencies for the years 1955 through 1960* as the result of the disallowance on audit of the taxpayers' returns for

* The Government filed proofs of claim for the years 1955 through 1964, but due to losses in the later years and adjustments for carrybacks thereof only those from 1955 through 1958 and 1960 are involved (Findings 22-24).

said years of 3% commissions or sales promotion expenses in the nature of "kickbacks" paid to managers, chefs and other purchasing agents of the clubs, hospitals, hotels and other customers of the husband's meat purveying business claimed as ordinary business expense deductions under Section 162(a) of the Internal Revenue Code, 26 U. S. C. 162(a) in the partnership income tax returns duly filed on behalf of said business, and the questions for determination are whether the disallowances of the claimed deductions should be sustained in whole or in part, and if sustained in any amount, whether the resultant liabilities are allowable as priority claims or relegated to the status of general claims by Section 64(a)(4) of the Bankruptcy Act, 11 U. S. C. 104(a)(4) as amended October 3, 1966 which limits the taxes eligible for priority treatment to those not released by a discharge in bankruptcy under the simultaneously adopted amendments to Section 17(a)(1) of the Act, 11 U. S. C. 35(a)(1) making taxes dischargeable which became legally due and owing more than three years preceding bankruptcy not excepted from such result by clause (c) of the first proviso thereto excluding taxes.

> "(c) which were not reported on a return made by the bankrupt(s) and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt(s)": *Section 17 (a)(1)(c) of the Bankruptcy Act, 11 U. S. C. 35(a) (1)(c).*

The business was conducted as a sole proprietorship by the husband bankrupt Abner Michaud from the time of its inception in 1938 until its termination in 1964, except in the years 1955 through 1961, including the years 1955 to

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

1960 here in issue, in which it was operated as a partnership in which said Michaud owned a 95% interest and one Nachman, 5% (Finding 5). The bankrupts filed joint husband-wife returns on a calendar year basis for the years in question, and the asserted deficiencies arise solely from the effect on the husband's income of the disallowance of the above referred to commissions or "kickbacks" claimed as ordinary business expense deductions in the partnership returns filed for the fiscal years ending March 31 in said years, the portion of said deficiencies applicable to Nachman's interest being adjudicated in separate proceedings and not here involved (Finding 10).

[1] It is conceded that the gross income of the business and the basis and amount of the disallowed deductions were fully and properly reported in the aforesaid partnership returns, and that the husband's portion of the resultant taxable income after the taking of said deductions was correctly set forth in the bankrupts' individual joint returns (Findings 12, 13, 17 and 18). Ninety day letters were mailed the taxpayers in respect to the asserted deficiencies as a result of the disallowance of the claimed deductions (Finding 26), and said bankrupts filed timely petitions for redeterminations of their liabilities in the Tax Court of the United States which were pending in said Court when their respective petitions under the Bankruptcy Act were filed in these proceedings December 2, 1965 and May 4, 1966 (Finding 27). No assessment for the asserted deficiencies was made in advance of the above mentioned filing dates although post-bankruptcy assessments were attempted therefor May 13, 1966 notwithstanding the pendency of the taxpayer's appellate proceedings

in the Tax Court of the United States transferred to the Bankruptcy Court (see *infra*) and the prohibition on such assessments provided in Section 6213 of the Internal Revenue Code and alluded to in Sub-section (c) of the 1966 amendments to Section 17(a)(1) of the Bankruptcy Act hereinabove quoted (Finding 28). That the Referee has jurisdiction to adjudicate the controversy as provided in Section 2A of the Bankruptcy Act as amended, 11 U. S. C. 11A, is stipulated to by the parties (Finding 29).

The grounds of the Government's objections to the allowance of the questioned payments as ordinary business expense deductions are (1) that they are in frustration of a clearly defined state and federal public policy, and (2) that for the most part, the recipients of said payments were not identified by name and address as required in connection with a settlement formula developed by the Government in compromising alleged deficiencies as a result thereof (Findings 15—17). The total liabilities in the event the public policy objection should be sustained are stipulated to amount to the sum of $94,652.73, plus applicable interest and the amount due on a reduced taxable income for 1960, while the amount thereof in the event said objection are sustainable only in respect to payments considered unsubstantiated because made to unidentified payees is $72,500 plus said interest and 1960 tax (Finding 24).

The public policy objection is based on the contention that the payments in question constitute an "unfair . . . or deceptive practice or device in commerce" within the meaning of the Packers and Stockyards Act of 1921, 7 U. S. C. 192, and are violative of state commercial bribery statutes

like the Pennsylvania Act of June 24, 1939, P. L. 872 Section 677, 18 P. S. 4667, New Jersey Statutes Anno. Sec. 28:170-88, Virginia Code Anno. Sec. 18.1-404, and North Carolina General Statutes Sec. 14-853 in force in most of the eastern seaboard states in which the business was transacted providing such payments constitute a criminal offense when made without the knowledge or consent of the recipients' employers.*

The taxpayer contented himself with testimony adduced on cross examination of the examining agent of the Internal Revenue Service that the custom and practice of making the complained of payments by persons engaged in the meat purveying industry was known to the Service and that the practice had become so universal by the year 1958 that it checked the returns of persons engaged in said business on a national basis and had adopted a formula for compromising disallowances of deductions claimed for said payments on the basis of allowing 50% thereof in computing an acceptable settlement of asserted deficiencies when the payments were "*substantiated*" or made to identified payees, and 25% thereof when "*unsubstantiated*" by reason of being made to unidentified payees (Findings 15 and 16). No other testimony was offered to establish the existence of the custom of making such payments or whether the employers of the payees consented to their receiving them or knew of the custom of their being made.

* While the record does not disclose the amount of business done in each state, more of it was transacted with customers and institutions in states other than Pennsylvania in the eastern United States than with those in Pennsylvania where the processing operations were conducted and from which the items were shipped (Findings 7 and 8).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

The Third Circuit Court of Appeals sustained business expense deductions for similar payments in Valetti v. C. I. R., 260 F. 2d 185 [2 AFTR 2d 5914], 3 Cir. (1958) when it was shown they were made pursuant to a universal custom in the taxpayer's business, but the universality of the custom there involved was established by a finding of the Tax Court in the opinion affirmed in said decision (28 T. C. 692), and the question of whether the payments were made with or without the consent of the recipients' employers does not appear to have been presented for the consideration of either tribunal. Rev. Rul. 62-194, C. B. 1962-2, 57 is to the effect that so-called "kickbacks" are not deductible when violative of federal or state law while Rev. Rul. 58-479, C. B. 1958-2, 60 permits deductions therefor when made with the employers' knowledge or consent. The question of the employers' consent was subsequently held controlling in Dixie Machine Welding and Metal Works, Inc. v. U. S., 315 F.2d 439 [13 AFTR 2d 1083], 5 Cir. (1963) in which deductions for such payments were disallowed, and because of the inconclusiveness of the testimony on the universality of the practice or custom of making the questioned payments throughout the taxpayer's industry and the lack of any testimony on the consent question, we have concluded that the objection that the payments are in violation and frustration of a clearly defined state and federal public policy must be sustained, and that the claim for the deficiencies in question should be allowed in the total amount stipulated to be in issue of $94,652.73 plus applicable interest and sums due for the year 1960 (Finding 24).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

We are not unmindful of the authorities holding that federal taxes are taxes on income and should not be assessed as a punishment for wrong doing relied on by the taxpayer,* but must conclude that the record evidence does not satisfy the burden of proof he is required to meet in establishing his entitlement to the claimed deductions. Moreover, the requirement of identification of payees is reasonable as it was shown the tax liabilities of some of the recipients were being investigated and in prosecution status (Finding 19), and it follows that the second objection of lack of substantiation because of failure to identify payees would have to be sustained with a resultant liability of $72,500 plus interest and 1960 taxes (Finding 24) in any event under the principle that the right to business expense deductions must be established agreeably to reasonable requirements and rules: Sandt v. C. I. R., 303 F. 2d 111, 3 A. L. R. 3d 864 [9 AFTR 2d 1470], 3 Cir. (1962), and Hirsch v. C. I. R., 315 F.2d 731 [11 AFTR 2d 1156], 9 Cir. (1963). Cp. Reg. 1.274-5 (b)(5) requiring identification of payees and other information concerning deductions such as those here claimed.

[2] Whether the claim should be accorded fourth priority treatment under the amendment to Section 64(a)(4) of the Bankruptcy Act, 11 U. S. C. 104(a)(4) effective

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* C. I. R. v. Tellier, 383 U. S. 687 [17 AFTR 2d 633] (1966); Commissioner v. Heininger, 320 U. S. 467 [31 AFTR 783] (1963); Commissioner v. Sullivan, 356 U. S. 27 [1 AFTR 2d 1158] (1958); Lilly v. Commissioner, 343 U. S. 90 [41 AFTR 591] (1951), etc.; Cf. Cammarano v. U. S., 358 U. S. 498 [3 AFTR 2d 697] (1959); Tank Truck Rentals v. Commissioner, 356 U. S. 30, 35 [1 AFTR 2d 1154] (1958); and Textile Mills Corporation v. Commissioner, 314 U. S. 326 [27 AFTR 322] (1941) affirming 117 F. 2d 62 [26 AFTR 259], 3 Cir. (1940).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

October 3, 1966 and by its terms applicable to cases pending on that date as well as future cases, which limits the eligibility for such treatment to taxes due and owing by the bankrupt not released by a discharge in bankruptcy, depends on whether said taxes are dischargeable under the simultaneously effective amendments to Section 17(a)(1)(c) of the Act, 11 U. S. C. 35(a)(1)(c) which provide.

> "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, . . . except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years in preceding bankruptcy: Provided, however, That a discharge in bankruptcy shall not release a bankrupt from any taxes . . . (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt."*

The important word in the terminology of clause (c) of the above proviso is the word *"and"* conjoining the dual requirement for its applicability that the taxes be not reported on a return made by the bankrupt *and* that they be

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* While the Court of Bankruptcy has unquestioned jurisdiction to deny discharges after hearing on objections filed thereto pursuant to Section 14(c) of the Bankruptcy Act, 11 U. S. C. 32(c), its authority to determine whether or not a particular debt is affected thereby is limited to situations in which the dischargeability question must be adjudicated as a prerequisite to passing on another matter over which it has jurisdiction, like the instant controversy in which the eligibility of the claim in issue for a distributive priority depends on whether or not it is dischargeable; Local Loan Co. v. Hunt, 292 U. S. 234 (1934); 1 Collier on Bankruptcy, 14th Ed., 1727-1734. (See H. R. 12250 and 9772 pending in the present Congress to remedy this anamolous situation by providing for unquestioned jurisdiction to pass on questions of the dischargeability of debts in all situations.)

not assessed by reason of a prohibition on assessment during the pendency of the taxpayer's administrative and judicial remedies. If Congress had intended to deny dischargeability in cases in which taxes were not reported on a return, and in addition thereto in which the Government was prevented from assessing a deficiency during the pendency of the taxpayer's appellate remedies, it would have provided that the discharge would not constitute a release from taxes.

> "which were not reported on a return made by the bankrupt *or* which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt".

But Congress did not do this, and clearly understandable and simply expressed legislative provisions require no interpretation and should be applied in accordance with the ordinary meaning of the words used, especially when as here they are contained in a remedial statute and such meaning is consistent with the liberal construction required to effectuate its intended purpose: 50 Am. Jur. 210, 415, 420 and cases cited. However, the intention of Congress not to deny the effect of a discharge to stale and ancient taxes due and owing for more than three years in a situation such as this where the facts and amounts of contested deficiencies are admittedly set forth in the taxpayers' returns (Findings 12, 13 and 17) is apparent not only from the words used, but from the history of the legislation as evidenced by the Committee Reports on the basis of which it was passed, viz.:

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

(1) Senate Report No. 999 to the 89th Congress, Second Session (1966) which contains the recommendations of the Finance Committee that the words *"date of assessment"* be substituted for the words *"legally due and owing"* in said legislation was expressly rejected, and the words *"legally due and owing"* were retained therein as recommended in Senate Report No. 1158 of the Judiciary Committee in which it was said:

> "In regard to the recommendations of the Committee on Finance set forth in Senate Report No. 999, the Committee on the Judiciary finds itself in agreement with, and adopts, the minority views of that committee opposing those recommendations as set forth on pages 22, 23 and 24 of Senate Report No. 999.",

thus showing that the suggestion that the assessability of a tax be the sole criterion for the inception of the period subsequent to which it would be dischargeable was disapproved.

(2) Senate Report No. 1158, above referred to, states there are two aspects to the problem, that of remedying the situation under prior law of "an honest but financially unfortunate debtor (being prevented) from making a fresh start unburdened by what may be an overwhelming liability for accumulated taxes", and the inequity resulting to other creditors from the uniform priority granted all tax claims, no matter how delinquent or stale, thus establishing, with the subject matter and other statements concerning it, the obviously remedial character of said legislation.

(3) Senator Ervin's statement on page 3 of the aforesaid Report No. 1158 of the Judiciary Committee that the prebankruptcy period prescribed as a prerequisite for the

dischargeability of taxes coincides with the three year statute of limitations for assessments in federal income tax cases shows that Congress intended to grant relief in a case like Mr. Michaud's in which the tax liabilities were fully disclosed in his returns but computed on a different theory than that asserted by the Government, as it is uniformly held in construing said statute of limitations (Section 6501(a) and (e) of the Internal Revenue Code, 26 U. S. C. 6501(a) and (e)) that a full disclosure of the liabilities in question is sufficient to keep them within the operation of said statute notwithstanding the fact that their computation may be incorrectly made or is on another basis than that of the Government: Colony, Inc. v. Commissioner, 357 U. S. 28 [1 AFTR 2d 1894] (1958); Davis v. Hightower, 230 F.2d 549 [49 AFTR 277], 5 Cir. (1956); Deakman-Wells Co., Inc. v. C. I. R., 213 F.2d 894 [45 AFTR 1666], 3 Cir. (1954) (Maris, J.); Uptegrove Lumber Co. v. C. I. R., 204 F. 2d 570 [43 AFTR 948], 3 Cir. (1953) (Hastie, J.); Genevieve B. Walker, 46.65 P-H T. C. 449 (1957).

Facts which would have presented the specific question here involved were alleged in a petition to a Court of Bankruptcy for a restraining order against collection of a tax liability determined in a decision of the Tax Court of the United States in the matter of Leon Allen Cohen, Bankrupt, 21 A. F. T. R. 2d 992, D. C. N. D. Ga. (1967), C. C. H. Bcy. Section 62,675, but the question could not be determined as contrary to the allegations in the petition, the evidence showed there was no disclosure of the liability in question or the facts giving rise to it in the taxpayer's return. The question was ruled upon, however, in the statute

of limitations case of Davis v. Hightower, 230 F. 2d 549, 553 [49 AFTR 277] (*supra*) where Tuttle, Circuit Judge, wrote:

> "The only way in which the taxpayer here could satisfy the government's requirement that he state his 'gross income' in a way to permit a tax computation of the amount the government claims is due, would be for him to abandon his claim that he was entitled to capital gains treatment of the sales in question. No such penalty was intended by Congress in extending the statutory period to 5 years in case of substantial omission."

Judge Maris said in Deakman-Wells Co., Inc. v. C. I. R., 213 F. 2d 894 [45 AFTR 1666] (*supra*):

> "It is accordingly sufficient if all items of gross income are disclosed in a schedule attached to the return in which the computation is made."

Said Chief Judge Hastie in Uptegrove Lumber Co. v. C. I. R., 204 F. 2d 570, 572 [43 AFTR 948] (*supra*):

> "In these circumstances we think it was the manifest purpose of Congress to make an exception to the 3 year statute of limitations which would apply only to situations where the taxpayer had failed to make a return of some taxable gain.
>
> "And this restriction is quite logical. For there are many places throughout an income tax return where a taxpayer may make arithmetical errors *or claim improper deductions with the result that his tax liability is understated.* If such errors are made in good faith at any place other than the gross income section, it is clear that the government must challenge them, if at all, within the normal 3 year limitation period" (Emphasis added).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

The case of Genevieve B. Walker, 46.65 P-H T. C. 449 expressly holds that the reporting of a capital gains transaction on an installment sale basis in a partnership return with the resultant computation being used as the gross income in the taxpayer's individual return as in the instant case constitutes a sufficient disclosure of the liability involved.

The legislation construed in the above cases (Section 6501(e) of the Internal Revenue Code, 26 U. S. C. 6501(e)) provides that "in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item" and while this language is not contained ipsis verbis in the proviso to Section 17(a)(1) of the Bankruptcy Act here involved, the terminology

> "taxes . . . not reported on a return . . .and not assessed . . . pending the exhaustion of administrative or judicial remedies"

is utilized rather than the words

> "tax liabilities . . . not reported on a return, etc.",

and it would seem that if Congress had intended the provision to be effective only in cases where the liabilities were legally and mathematically correct as computed in the taxpayer's return it would have used said term *"tax liabilities"* rather than *"taxes"*.

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

The above conclusion appears especially inescapable in view of the fact that in considering the Amendments to Section 17 of the Bankruptcy Act here involved, the Committee on Judiciary had the above referred to statute of limitations on assessments expressly in mind and stated it was analogous to said Amendments in Senate Report No. 1158 hereinabove quoted, and the requirements of that legislation are uniformly held to be satisfied if the return contains an explanation of the manner in which the liabilities were computed (cases *supra*). The contrary statement that the employed language connotes *"liabilities"* rather than information concerning their computation at 1 Collier on Bankruptcy, 14th Ed., 1620 is unsupported by reasoning or authority and is difficult to reconcile with the accompanying text or understand as the author assumes that tax claims are made perpetually enforcible and nondischargeable when an assessed lien therefor is recorded by the second proviso to Section 17(a)(1) of the Bankruptcy Act, 11 U. S. C. 35(a)(1)*, and feels that irrespective of the additional requirement that the tax be not reported on a return the three year dischargeability period should be tolled in all situations in which the Government was prevented from acquiring this perpetually nondischargeable status for its claims by being prohibited from making assessments therefor prior to the bankruptcy filing date:

From 1 Collier on Bankruptcy, 14th Ed., 1620, 1621:

> "First of all, the exception relates to taxes due more than three years before bankruptcy 'which were not reported on a return'. This language should mean

* *"And provided further,* That a discharge in bankruptcy shall not release or affect any tax lien ;"

where the tax liability was not reported as distinguished from the information giving rise to the liability.

"Secondly, the exception applies where assessment before bankruptcy is prohibited because judicial or administrative remedies available to the taxpayer-bankrupt have not been exhausted. . . . The Government's protection, once the stay of assessment is lifted, is found in its ability to assess (create a lien) and file notice of the lien (perfect it) so that it will remove the tax to the second proviso and render it non-dischargeable.

"If, on the other hand, the administrative or judicial proceedings are still pending at bankruptcy, and the Government remains unable at that date to assess the tax, it would be non-dischargeable within this exception."

These interpretations, if valid, would emasculate if not annihilate the remedial effects of the legislation conceded at 1 Collier, 14th Ed., 1262, to require a liberal construction in favor of the benefits attempted to be conferred,* and that they are unsound appears *inter alia* from the fallaciousness of the following premises on which they are based:

(1) That the exception applies if the Government is prohibited from assessing liens by the pendency of the taxpayer's remedies irrespective of whether or not taxes or liabilities therefor are reported on a return;

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* From 1 Collier on Bankruptcy, 14th Ed., 1262:

"Statutory provisions regulating discharges are remedial in their nature. They should be construed liberally with the purpose of carrying into effect the legislative intent, and the grounds in opposition enumerated in Section 14c should not be extended by construction."

(2) That the term *"taxes"* connotes a legally and mathematically correct computation of liabilities whether or not the basis of said liabilities is set forth in the return;

(3) That a tax claim is rendered perpetually nondischargeable and enforcible against after-acquired assets by the obtaining of a perfected lien therefor; and

(4) That irrespective of the words of the statute it should not be construed so as to permit the three year dischargeability period to run under any circumstances if the Government was prevented from obtaining such pre-bankruptcy lien.

After appearing to recognize that for the exception to apply it is necessary not only that the Government be prevented from making assessments by the pendency of the taxpayer's remedies, but that the taxes be not reported on a return, the author concludes that in all instances in which judicial remedies have been pending to the date of bankruptcy the dischargeability provisions are inapplicable because of the inability of the Government to convert its tax claims to perfected liens, and this irrespective of whether taxes ("liabilities") were reported on a return. Further, the interpretations ignore the implication that the power of making an assessment should not be of primary importance which clearly arises from the rejection by Congress of the Senate Finance Committee's suggestion that the assessment date be substituted for the time taxes become legally due and owing as the commencement of the period after which they shall be dischargeable (*supra*). In addition, the view that the word *"taxes"* mean *"liabilities"* does not take into consideration the plight of an honest

taxpayer attempting to have his rights adjudicated in accordance with his good faith tenets and opinions and those of his advisors being discriminated against in favor of taxpayers who compute their liabilities in accordance with the Government's interpretations commented on in Davis v. Hightower, 230 F. 2d 549, 553 [49 AFTR 277], and other cases, *supra*. Finally, the view that a tax claim becomes perpetually collectible and nondischargeable once a lien therefor has been noticed is disagreed with by William T. Plumb, Jr. in his article on "Federal Tax Liens and Priorities in Bankruptcy—Recent Developments", 43 Ref. J. 37, 44 and 45 (Apr. 1969)* and every other writer on the subject of the lien proviso whose works we have read and repudiated in every case on the effect thereof of which we are cognizant that has come before the Courts: *In re* Braund, 289 F. Supp. 604 [21 AFTR 2d 604], D. C. C. D. Cal., 1968, 22 AFTR 2d 5493 (Hill, D. J.), affirming opinion of Referee Champlin at CCH Bcy 62,624 (1968) [22 AFTR 2d 5493]; *In re* Carlson, 292 F. Supp. 778, D. C. C. D. Cal., 1968 (Hauk, D. J.); *In re* Luks, CCH Bcy 62,881, D. C. N. D. Ohio, 1968 [23 AFTR 2d 69-575] (Gnau, Referee); and an unreported case referred to along with *In re* Carlson, *supra*, in Footnote No. 2 to the opinion in *In re* Braund, *supra*, United States v. Ulises A. Sanabria, No. 67-C-505 in the Northern District of Illinois, Eastern Division.

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* The conclusion herein reached as to the saving effect of disclosure of the basis of the liabilities reported in a taxpayer's return is also disagreed with in Footnote No. 110 on Page 44 of said article on the authority of the case of Leon Allen Cohen, Bankrupt, 21 AFTR 2d 992, D. C. N. D. Ga., 1967, CCH Bcy Section 62,675, *supra*, in which said question was alluded to but not considered in depth or before the Court.

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

That a pre-bankruptcy lien is a right *in rem* against specific assets that can be safeguarded against the effects of dischargeability provisions such as are here involved without according immortality to the underlying claims in such manner as to make them forever enforcible against after-acquired property as contended in Collier was aptly explained by Judge Irving Hill in the case of *In re* Braund, 289 F. Supp. 604, 608 [21 AFTR 2d 604], *supra*:

> "The government contends that the statute should be construed to limit its rehabilitative benefits to cases where the older tax liabilities have not been made the subject of a noticed lien. Once a lien has been noticed, the government reasons, the statute says that the lien is not 'affected' by the discharge, which means that the lien must continue to have the power to pick up after-acquired property. Under this reasoning, the tax claim is not discharged in whole or in part. So, if the government's view is adopted, whether a bankrupt individual succeeds in getting out from under his 'overwhelming liability for accumulated taxes' *depends on the purely fortuitous circumstance of whether the taxing authority has as yet noticed a lien based upon that tax liability at the moment the bankruptcy is filed.* (Emphasis added.)
>
> "I do not read the language of the statute and particularly the second proviso, as compelling such a result. A close reading of the entire statute and of the legislative history convinces me that the second proviso has a clearly ascertainable purpose different from that advocated by the government, a purpose consistent with the rehabilitative purposes of the amendment. It seems clear to me that the second proviso was inserted so as to make clear that where a lien had attached to certain property at the time of the bankruptcy, the government could go ahead and realize on that lien and apply the proceeds of that property to the

unpaid taxes despite the earlier language that a discharge in bankruptcy 'shall release' the bankrupt from the tax liability in question. In other words, Congress was saying that to the extent the lien had, before the bankruptcy, attached to property, later discharge in bankruptcy did not affect the right of the government to proceed against that property under the lien. To that extent, but to that extent only, the discharge would not 'release or affect' the tax lien. But if the tax liability is not paid in full by the proceeds of such property, the remainder of the tax liability is 'released' and no after-acquired property can be subjected to any lien because the lien died with the release of the underlying obligation."

The similarly unjust and discriminatory consequences of a holding that whether tax claims are barred from assessment after the three year period provided therefor by Section 6501 of the Internal Revenue Code, 26 U. S. C. 6501 should depend on the irrelevant circumstance of whether the taxpayer computed his liabilities in conformity with ultimately approved interpretations of the Internal Revenue authorities in his return when his receipts of income and bona fide deductions are fully disclosed therein was explained in Davis v. Hightower, 230 F. 2d 549, 553 [49 AFTR 277] and the other cases quoted *supra*, and the terms required for the dischargeability of such claims under the 1966 amendments to Section 17(a)(1) of the Bankruptcy Act, 11 U. S. C. 35(a)(1) is not only identical with but was adverted to as being analogous to said assessment period in the Report of the Senate Judiciary Committee on the strength of which said amendments were adopted (see *supra*).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

Dischargeability is not denied even to taxes more than three years overdue for which no return at all was filed if assessed more than a year before the bankruptcy filing date under clause (b) of the very proviso to said amendments here involved:

> "Provided, however, That a discharge in bankruptcy shall not release a bankrupt from any taxes . . . (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law": Section 17 (a) (1) (b) of the Bankruptcy Act, 35 U. S. C. (a) (1) (b).*

It follows that the objections to priority treatment being accorded the claim of the United States Internal Revenue Service for asserted tax deficiencies from disallowances of ordinary business expense deductions claimed against income receipts fully accounted for in the taxpayers' returns for periods antedating the bankruptcy filing dates by more than four years on the ground that such taxes are dischargeable should be sustained, and that said claim should be allowed as a general, not a priority, claim.

Order

At Erie, in the Western District of Pennsylvania, this 10th day of October, 1969, for the reasons above and in the Findings of Fact and Conclusions of Law hereunto appended set forth, It Is Ordered, Adjudged and Decreed:

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* Note that Congress adopted in express words in this quoted clause (b), the holding of the Braund and other cases *supra,* that a pre-bankruptcy assessment does not by itself prevent the subject taxes from being discharged.

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

(1) That the objections of trustee and bankrupts to the allowance of the claim of the United States Internal Revenue Service for income taxes due and owing by the within named bankrupts for the years 1955 and subsequent years prior to the filing dates of the within proceedings as a priority tax claim be, and they hereby are, sustained and the objections to its allowance as a general claim be, and they hereby are, overruled and dismissed;

(2) That the aforesaid claim of the United States Internal Revenue Service be, and it hereby is, allowed as a general claim in the sum of $94,652.73 plus applicable interest to the filing date of the Arrangement petition and the amount due for the year 1960 on taxable income not in excess of $44,000.00 and said interest; and

(3) That the within named bankrupts, Abner Michaud and Alyce E. Michaud, be, and they hereby are, released and discharged from all and every liability in respect to said taxes and interest and penalties thereon.

Findings Of Fact

(1) The taxpayer Abner Michaud filed a petition for an Arrangement under Chapter XI of the Bankruptcy Act at No. 65-126 Erie on December 2, 1965 in one of the within captioned consolidated proceedings, and was adjudicated a bankrupt on his voluntary withdrawal of said petition and request for such adjudication October 4, 1966.

(2) The taxpayer Alyce E. Michaud, wife of the aforesaid Abner Michaud, filed her voluntary petition in ordinary bankruptcy on which she was automatically adjudicated May 4, 1966 at No. 66-64 Erie in the other of said within captioned consolidated proceedings.

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

(3) An order discharging said bankrupts from all debts and claims provable against their estates, except such debts as are excepted by the Bankruptcy Act from the operation of a discharge in bankruptcy, was issued April 17, 1967 after expiration of the time for filing objections thereto.

(4) The husband bankrupt, Abner Michaud, conducted a meat processing and distributing business known as A. Michaud Company in Philadelphia, Pennsylvania from October 15, 1938 until the latter part of 1964 when it was incorporated under the name of A. Michaud Company, Inc. and moved to North East, in Erie County, Pennsylvania (Pages 43 and 167).

(5) Said business was conducted as a sole proprietorship by Abner Michaud in the years 1938 through 1964, except the years 1955 through 1961, including those here involved, in which it was operated as a partnership in which said Michaud had a 95% interest and one Hans Nachman a 5% interest (Pages 22, 101).

(6) The above meat processing and distributing business consisted in the purchasing of dressed primal cuts of beef, lamb, pork and veal and severing them into smaller and easier to handle cuts such as steaks, chops and roasts, and freezing and storing said cuts and selling and supplying them to hotels, restaurants, colleges, hospitals and other institutions which customarily make larger than usual purchases of such meats (Page 167).

(7) The principal place in which the foregoing cutting and freezing operations of the business were conducted, and from which the described meat items were sold and

shipped, was located during the years in question at Hancock and Oxford Streets, Philadelphia and the customers and institutions served were located in the states of Pennsylvania, New Jersey, New York, Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Texas, and elsewhere throughout the Eastern United States (Pages 169, 170).

(8) The record does not disclose the volume of business done by the taxpayer in each particular state, but more of it was transacted outside than inside the state of Pennsylvania (Page 170).

(9) The alleged tax deficiencies at issue in these proceedings arise solely from the income derived by the bankrupt Abner Michaud from his 95% interest in the A. Michaud Company during the years 1955 through 1960 as computed on partnership returns filed on behalf of said A. Michaud Company and reported on joint husband and wife returns filed on a calendar year basis by the bankrupts, Abner Michaud and his wife, Alyce E. Michaud (Pages 22, 101).

(10) The portion of such income attributable to Nachman's 5% interest in the partnership during said years has been asserted against said Nachman in separate proceedings which we are advised by counsel have not yet been disposed of (Pages 22, 101).

(11) Partnership returns were filed on behalf of the A. Michaud Company for the fiscal years ending March 31 of each of the years in question, and the deficiencies asserted by the government arise from the disallowances of payments of a 3% commission to managers, chefs, and

other purchasing agents of the customers of the business and claimed as ordinary business expense deductions in said partnership returns (Pages 21, 191).

(12) The gross income of the partnership business was correctly and fully reported in all of the above partnership returns, and the basis and amounts of the disallowed deductions were also correctly set forth therein and fully supported by the records of the taxpayer (Exhibits 5 and 6, and *intera alia* Pages 105, 150, 151).

(13) The individual returns filed jointly by the husband and wife bankrupts correctly reflected the income attributable to the husband's interest in the partnership in the years in question on the basis of allowing the aforesaid business expense deductions as claimed and set forth in the partnership returns.

(14) The payments of the A. Michaud Company to managers, chefs and other purchasing agents of customers of said business had been uniformly claimed as business expense deductions and allowed on the returns filed on behalf of said business from the time of its inception as an individual proprietorship in 1938 until the year 1958 when the partnership returns filed in behalf of said business were audited and said payments were disallowed retroactively for a three year period beginning with the fiscal year ending March 31, 1955. Said payments were subsequently disallowed *inter alia* for the years 1958 through 1960 also here involved (Page 39).

(15) The custom of paying the aforesaid rebates or commissions to purchasing agents of customers (they were termed "*sales promotion expenses*" by the taxpayers and

"kickbacks" by the government) was known by the Internal Revenue officers to be universally followed by persons engaged in the meat purveyors' industry in the Philadelphia area in the years in question (Page 93), and by 1958 it checked the returns of persons engaged in said industry on a national basis and had adopted a formula for compromising disallowances of claimed deductions for said payments (Pages 92, 93, 95, 97). See, also, Counsel's description of the practice at Pages 12 *et seq.* which was neither excepted to nor contradicted in the answering statement at Pages 29 *et seq.* and which was understood to constitute a correct statement of facts except where so questioned (Pages 10, 11, 23).

(16) The compromise formula followed by the government in approving settlements with taxpayers engaged in the meat purveyors' industry in respect to the described payments was to allow deductions therefor on the basis of allowing deductions for 50% of said payments in computing the tax liability thereon in respect to payments to identified payees and 25% thereof in respect to payments to unidentified payees. The payments to identified recipients or payees were considered *"substantiated"* for the purpose of the formula computations, and those made to unidentified payees, *"unsubstantiated"* in respect thereto (Pages 104, 105).

(17) The fact and amount of the above described payments claimed as deductions in the returns filed on behalf of the business of the husband taxpayer are agreed to by the government, and they were disallowed solely because (1) they alleged said payments were contrary to public

policy and (2) because such of said payments as to which the payees were not identified were disallowed on the additional ground that they were considered *"unsubstantiated"* in accordance with the above requirements, *i.e.*, they are conceded to have been made in the amounts claimed, the only question other than public policy considerations being to whom they were made (Pages 105, 142, 149, 150, 151).

(18) It is conceded that the deductions were itemized in the taxpayer's cash book (Page 150) and a bundle of representative vouchers was introduced in evidence (Government Exhibit 9). Samples of deductions considered *"unsubstantiated"* under the above described settlement requirements (Exhibits 10, 11 and 13) and those considered *"substantiated"* thereunder (Exhibit 13) were explained at Pages 125-131.

(19) The requirement that payees be identified was reasonable as the tax liabilities of some of them were subject to investigation and under prosecution status (Page 142).

(20) Negotiations for a compromise on the basis of allowing deductions of 50% of the taxpayer's rebates or payments to identified payees and 25% to those that were unidentified under the above described formula culminated in the preparations by the appellate division of an offer in compromise which the taxpayer executed but which was not accepted because of his subsequent failure to identify all of the persons to whom the payments were made. (Exhibit 8 as explained at Pages 98-102).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

(21) An elaborate stipulation of the amounts of the deductions considered *"substantiated"* and those considered *"unsubstantiated"* under the above formula was prepared by Agent Johnson during the course of the trial and introduced in evidence as Government's Exhibit "A", and the total tax deficiencies or liabilities resulting respectively from a disallowance of said *"substantiated" and "unsubstantiated"* deductions as shown on the stipulation for the years 1955 through 1960 were summarized by said agent in the sum of $97,500.00 if the disallowance of only the *"unsubstantiated"* deductions should be sustained (Page 156), and $135,001.64 if the disallowance of all of said deductions (*i.e.*, the *"substantiated"* as well as the *"unsubstantiated"* payments) should be sustained (Page 159). (See itemized schedules in Finding 24 *infra.*).

(22) It is admitted in the testimony and in the stipulation, Government's Exhibit "A", above, that because of losses suffered by the business in the years 1962, 1963 and 1964 no tax deficiencies are owing in said years.

(23) It is found from the testimony of Agent Johnson at Page 164, that due to adjustments for carry back losses in 1961, 1962 and 1963, and in the year 1964, all tax liabilities for the year 1959 are eliminated, and those for the year 1960 are reduced to those applicable to taxable income of between $43,000 and $44,000 (Page 164).

(24) The amount of the tax liabilities resulting respectively from a disallowance of payments to unidentified payees, and from a disallowance of all of the payments on the ground that they are against public policy, are found from the stipulation, Government's Exhibit "A", and the above referred to testimony, as follows:

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

Year	*Tax liabilities if only disallowances of unidentified items are sustained (Page 156)*		*Tax liabilities if all disallowances are sustained (Page 159)*	
1955	$31,000.00		$36,085.73	
1956	21,000.00		26,194.32	
1957	19,000.00		27,962.25	
1958	1,500.00		4,410.43	
1959	10,500.00		17,450.87	
1960	14,500.00	$97,500.00	22,898.04	$135,001.64
Less (Page 164):				
1959	$10,500.00		$17,450.87	
1960	14,500.00	25,000.00	22,898.04	40,348.91
Balance		$72,500.00		$ 94,652.73

Said amounts are subject to adjustment for applicable interest to the filing date of the Chapter XI petition December 2, 1965 and the addition thereto of any amount due for the year 1960 on a reduced taxable income between $43,000 and $44,000 (Finding No. 23 *supra*).

(25) The aforesaid balances of the disputed liabilities computed under the above hypothesis include adjustments for disallowed and recomputed depreciation deductions and certain small items relating to partners' salaries and insufficiently proved wage and miscellaneous expenses agreed to be the taxpayers and shown on the stipulation, Government's Exhibit "A" (Pages 23, 105, 106, 108).

(26) When the proposed settlement was not consummated, the government disallowed all of the above described payments to customer representatives, and a statutory notice or 90 day letter was mailed to the debtors May 6,

1963 with regard to the resultant claimed deficiencies for the years ending December 31, 1955, 1956 and 1957, and March 24, 1964 for said deficiencies for the years ending December 31, 1958, 1959 and 1960 (Exhibits 5 and 6) *viz.:*

Taxable Year Ended	*Deficiency*
December 31, 1955	$ 36,085.73
December 31, 1956	26,194.32
December 31, 1957	27,962.25
December 31, 1958	13,526.13
December 31, 1959	31,305.64
December 31, 1960	39,571.42
Total	$174,645.50

(27) The taxpayer filed petitions for redetermination of said deficiencies in the Tax Court of the United States within 90 days of receiving each of the above described notices, and proceedings thereon were pending at Docket Nos. 380963 and 257364 in said Court at the time of the filings of the within captioned consolidated husband and wife proceedings under the Bankruptcy Act. An Answer to the petition was filed by the Commissioner and the case was at issue but not tried or determined on said filing dates (Paragraphs 18 and 20 of Government's Requests for Findings of Fact and colloquies of counsel, *inter alia* at Pages 3-6).

(28) No pre-bankruptcy assessments were made for the tax deficiencies herein claimed, but post-bankruptcy assessments were attempted therefor May 13, 1966 for the years 1955 through 1960 (Government Exhibit 1).

Appendix C—Memorandum and Order of the Referee in Bankruptcy (October 10, 1969).

(29) It was stipulated that the proceedings relative to the controversy pending in the Tax Court of the United States, as above, shall be considered transferred to the Court of Bankruptcy, and that the Referee has jurisdiction to adjudicate same subject to the rights of review and appeal provided for in the Bankruptcy Act (Pages 3 and 4).

Conclusions Of Law

(1) The objections of the trustee and bankrupts to the allowance of the claim of the United States Internal Revenue Service for income taxes due and owing by the within named bankrupts for the years 1955 and subsequent years prior to the filing dates of the within proceedings as a priority tax claim should be sustained and the objections to its allowance as a general claim should be overruled and dismissed.

(2) The aforesaid claim of the United States Internal Revenue Service should be allowed as a general claim in the sum of $94,652.73 plus applicable interest to the filing date of the Arrangement petition and the amount due for the year 1960 on taxable income not in excess of $44,000.00 and said interest.

(3) The within named bankrupts, Abner Michaud and Alyce E. Michaud, should be released and discharged from all and every liability in respect to said taxes and interest and penalties thereon.

Appendix D—Bankruptcy Act Section 17 and Section 64. Also Internal Revenue Code of 1954 (26 U. S. C.): Sections 6501(a) and (e)

BANKRUPTCY ACT:

Sec. 17 [11 U. S. C. 35, as amended by Sec. 2, Act of July 5, 1966, P. L. 89-496, 80 Stat. 270]. *Debts Not Affected by a Discharge.* a. A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided, However,* That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat, or (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over; but a discharge shall not be a bar to any remedies available under applicable law to the United States or to any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this Act: *And provided further,* That a

discharge in bankruptcy shall not release or affect any tax lien; • • •

Sec. 64 [11 U. S. C. 104, as amended by Sec. 3, Act of July 5, 1966, *supra*]. *Debts Which Have Priority.*

a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be • • • (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; • • •

INTERNAL REVENUE CODE OF 1954 (26 U. S. C.)

Sec. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) GENERAL RULE.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was

paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

• • •

(e) SUBSTANTIAL OMISSION OF ITEMS.—Except as otherwise provided in subsection (c)—

(1) INCOME TAXES.—In the case of any tax imposed by subtitle A—

(A) GENERAL RULE—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

Appendix E—Senate Report No. 1158 to the 89th Congress (1966)

THE Committee on the Judiciary, to which was referred the bill (H. R. 3438) to amend the Bankruptcy Act with respect to limiting the priority and nondischargeability of taxes in bankruptcy, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

PURPOSE

The purpose of the bill is to make dischargeable in bankruptcy debts for taxes which became legally due and owing more than 3 years preceding bankruptcy, and to limit the priority accorded to taxes in the distribution of bankrupt estates to those taxes which became legally due and owing within 3 years preceding bankruptcy.

STATEMENT

The Committee on the Judiciary favorably reported to the Senate the companion Senate bill, S. 976 on March 10, 1965. (S. Rept. 114.)

The committee reaffirms its favorable recommendation of this legislation and recommends that H. R. 3438 be enacted.

The Senate bill S. 976 was referred to the Senate Committee on Finance on July 28, 1965, for that committee's recommendations. Subsequently, the companion House bill, H. R. 3438, was approved by the House of Representatives and was referred to the Senate Committee on Finance. On February 16, 1966, the Senate Committee on Finance reported S. 976 and H. R. 3438 to the Senate with their recommendations (S. Rept. 996 and S. Rept. 998, with a

discussion of its recommendations in S. Rept. 999 accompanying H. R. 136). The two bills were then referred by the Senate on March 9, 1966, to the Senate Committee on the Judiciary. The Committee on the Judiciary now favorably reports to the Senate H. R. 3438.

In its favorable report on H. R. 3438, the Committee on the Judiciary of the House of Representatives said:

> The fundamental policy of the Bankruptcy Act is to provide a means for (1) the effective rehabilitation of the bankrupt and (2) the equitable distribution of his assets among his creditors. These basic considerations are involved in the problem to which this bill is addressed.
>
> Under existing law debts for taxes are not affected by a discharge in bankruptcy (sec. 17a(1) of the Bankruptcy Act, 11 U. S. C. 35(a) (1)). Similarly, taxes are entitled to a priority of payment, in advance of the payment of any dividend to general creditors, which is unlimited as to time (sec. 64a(4), 11 U. S. C. 104(a) (4)). This applies to all taxes whether due to Federal, State, or local governments. Although taxes have enjoyed this special status for many years, the enormous increase in the tax burden during recent years and the consequent impact on both the distribution of a bankrupt's estate and his financial rehabilitation, require a modification of that status.
>
> There are two aspects to the problem. The first of these involves the nondischargeability of taxes under section 17a(1) of the present law. Frequently, this prevents an honest but financially unfortunate debtor from making a fresh start unburdened by what may be an overwhelming liability for accumulated taxes. The large proportion of individual and commercial income now consumed by various taxes makes the problem especially acute. Furthermore, the nondischarge-

ability feature of the law operates in a manner which is unfairly discriminatory against the private individual or the unincorporated small businessman. Although a corporate bankrupt is theoretically not discharged, the corporation normally ceases to exist upon bankruptcy and unsatisfied tax claims, as well as all other unsatisfied claims, are without further recourse even though the enterprise may continue in a new corporate form.

The committee believes, therefore, that consistency with the rehabilitory purpose of the Bankruptcy Act, as well as fairness to individuals demands some time limit upon the extent of taxes excepted from discharge. The committee recognizes the fact that different types of taxes present different problems to tax collectors. The accuracy of some types of tax returns can be determined immediately. Others, like income taxes, require some time to audit. Rather than attempt a classification of the enormous variety of Federal, State, municipal, county, city, village, and various district taxes for the purpose of establishing varying limits on dischargeability, the committee set a 3-year period for all taxes. It is believed that such a period will not impose an unrealistic or unfair burden upon the tax authorities in auditing returns and assessing deficiencies. In fact, the period coincides with the 3-year statute of limitations for assessments in Federal income tax cases. The fact that tax claims for the 3 years preceding bankruptcy will not be discharged should serve to discourage recourse to bankruptcy as a facile device for evading tax obligations. At the same time it will become feasible for an industrious debtor to reestablish himself as a productive and taxpaying member of society.

While, under this bill, unsecured tax claims due and owing more than 3 years prior to bankruptcy would be dischargeable, there is no intention to place any time limit on otherwise valid tax liens. As with other secured claims like mortgages and conditional sales

contracts, the purpose of the lien is to give the creditor a property interest which is indefeasible in bankruptcy. Thus, to the extent that the tax authorities may satisfy their claims out of the security they hold they will be unaffected by the discharge regardless of the fact that the underlying debt may include taxes for years prior to the 3-year period preceding bankruptcy. The second proviso to section 17a(1) proposed by section 2 of this bill emphasizes this legislative intent. There is no intention to alter the relative position in the distribution of the bankrupt's assets which is now given to a tax lien on personalty unaccompanied by possession by the postponement provision in section 67c.

Since the purpose of this bill is to provide relief for the financially unfortunate and not to create a tax evasion device, section 2 of the bill specifically excepts from discharge taxes "which were not assessed in any case in which the bankrupt failed to make a return required by law," or with respect to which he had made a false or fraudulent return or which he had otherwise attempted to evade.

It is interesting to note that under the English Bankruptcy Act and the laws of several of the Commonwealth nations, claims for taxes are discharged except for debts arising from an offense against a statute relating to any branch of the public revenue. Even as to these debts, the English law provides that the Treasury may certify consent to their discharge. (English Bankruptcy Act, 1914 (4 and 5 Geo. 5c 59) s. 28(1)a, 2 Halsbury's Laws of England, third edition, p. 539.)

The second aspect of the problem involves the equitable distribution of the assets of the bankrupt's estate among creditors. Under the Bankruptcy Act, certain types of unsecured claims are given a statutory advantage in the distribution of the bankrupt's estate. These

priority claimants are to be distinguished from the secured creditor who has a property right which entitles him to be paid out of the assets against which the security attaches. The priority claimant, on the other hand is an unsecured creditor who, by law, as a matter of social policy, has been placed in a position superior to that of the unsecured creditors. Thus, administrative expenses, wage claims, taxes, and rent claims where State law gives a priority to landlords, are all paid before general creditors may share in the distribution under the Bankruptcy Act. The wage priority is restricted to $600 per claimant earned within 3 months prior to bankruptcy. Similarly, the rent priority is restricted to the amount due for actual use and occupancy within 3 months before bankruptcy. However, there is no time limit under the present law on the priority accorded taxes.

The result has frequently been that tax collectors, assured of a prior claim on the assets of a failing debtor and assured of the nondischargeability of uncollectible tax claims, have allowed taxes to accumulate and remain unpaid for long periods of time. With the proliferation of new taxes and the increased rates of old taxes, often little or nothing is left for distribution to general creditors who provided goods and services to the bankrupt.

The committee has received hundreds of letters from business firms all over the country complaining about this situation. Although a creditor can protect himself to some degree by requiring periodic financial statements from the bankrupt, there are cases in which the true extent of tax liability may not be known, even to the debtor, as where there are unsettled accounting or legal questions. Nor is a creditor protected from a dishonest debtor who issues a false statement of his tax liability. While this may result in barring the debtor's discharge, the Government still has a tax priority which may be large enough to preclude the creditor's participation in the distribution of the

debtor's assets. Ultimately, however, the issue would appear to resolve into whether the Government as a creditor should bear part of the economic burden of business failures through the loss of some of its tax claims which it has allowed to accumulate over a long period of years.

The committee believes that limiting tax priority to those taxes which became due and owing within 3 years preceding bankruptcy adequately safeguards the public's interest in the collection of revenues while at the same time limiting the impact of long accumulated, unsecured tax claims on general creditors. The imposition of such a limitation will induce taxing authorities to act to prevent large accumulations of tax claims.

In establishing what this limitation should be, the committee was concerned with its effect in forcing tax authorities to precipitate business failures in safeguarding the interest of the Government. For that reason, the committee rejected the 1-year limitation on both priority and nondischargeability which was proposed when the matter was considered in the 85th Congress. However, the committee believes that a business which is unable to meet tax obligations extending back more than 3 years is unlikely to recover financial viability. The continued failure to protect the Government's tax interest by instituting liens or distraint warrants generally results only in compounding the loss suffered by general creditors and the Government as well. Furthermore, the effect of forcing the financial issue may, in some cases, be to save the debtor before his position becomes helpless.

The unlimited priority now enjoyed by taxes in bankruptcy proceedings in the United States is inconsistent with the practice in most commercial countries. Thus, in England the priority is limited to parochial or other local taxes (such as levies on spindles, water rates, drainage rates, etc.) due from the bankrupt at the date of bankruptcy and having become due and payable

within 12 months next before that time, and all assessed taxes, land taxes, and property or income taxes assessed on the bankrupt or insolvent up to the 5th of April preceding bankruptcy and not exceeding in the whole 1 years assessment; and sums due at the date of bankruptcy as an employer on account of tax deductions for the 12 months next before that date. (English Bankruptcy Act 1914 (4 and 5 Geo. 5c 59) s. 33(1) (a), (5).) The Crown, however, has a choice of any year and is not confined to the year of assessment immediately preceding the bankruptcy. (*Re Campbell Commercial Bank of Scotland v. Campbell* (1923) 10 T. C. 585; *re Pratt, Inland Revenue Commissioners v. Phillips* (1915), Ch. 225, C. A.; (1950) 2 All E. R. 994.) See 2 Halsbury's Laws of England, third edition, pages 486-487.

Similarly, in Australia, the tax priority is limited to 1 year (Bankruptcy Act, 1924 secs. 5(3), 84(h), XXII Commonwealth Acts, 84, 113). In France, there is a 2-year priority for income tax (Code Général des Impots of 1950, secs. 1920(1), as amended by law of February 7, 1953, sec. 61). In Germany, tax claims enjoy a 1-year priority (Bankruptcy Act of 1898, sec. 61(2), 1898 Reichsgesetzblatt 612; Arrangement Law of 1935, sec. 26, 1935 id. I:321). In Belgium, the priority is for the last and current year (7 Fredericq, Droit Commercial Belge, 551, 556 (1949)).

This bill is supported in principle by the—

National Bankruptcy Conference.

American Institute of Certified Public Accountants.

Commercial Law League of America.

National Association of Credit Men.

The American Institute of Accountants

Similar bills passed the House in the 85th, 86th, 87th, and 88th Congresses, but were not acted on by the Senate.

Appendix E—Senate Report No. 1158 to the 89th Congress (1966).

> The Committee on the Judiciary believes that H. R. 3438 presents a most desirable and necessary resolution of the conflict between the demands of the public revenue on the one hand and the underlying purposes of the Bankruptcy Act on the other. The committee, therefore, recommends that this bill be given favorable consideration by the House.

The Committee on the Judiciary of the Senate agrees with the recommendations of the Committee on the Judiciary of the House of Representatives in this matter and, consistent with its earlier favorable report on the companion Senate bill, S. 976, recommends it favorably.

In regard to the recommendations of the Committee on Finance set forth in Senate Report No. 999, the Committee on the Judiciary finds itself in agreement with, and adopts, the minority views of that committee opposing those recommendations as set forth on pages 22, 23, and 24 of Senate Report No. 999.

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-51

ABNER MICHAUD, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum and order of the referee in bankruptcy (Pet. App. 31a-61a) are unofficially reported at 24 A.F.T.R. 2d 5978. The opinion and order of the district court (Pet. App. 15a-30a) affirming the order of the referee are reported at 317 F. Supp. 1002. The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 458 F. 2d 953.

JURISDICTION

The judgment of the court of appeals was entered on April 10, 1972. The petition for a writ of certiorari was filed on July 8, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether under Sections 17a(1) and 64a(4) of the Bankruptcy Act the government's claim for income tax deficiencies, for taxes that became due more than three years prior to bankruptcy but for which the deficiencies were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of judicial remedies available to and pursued by the bankrupts, was entitled to priority.

STATUTES INVOLVED

The pertinent statutes are set forth at Pet. App. 62a-64a.

STATEMENT

This case involves unpaid deficiencies in federal income taxes for the years 1955, 1956, 1957, 1958, and 1960, which were determined by the referee in bankruptcy to be in an amount in excess of $94,652.73, plus interest to the date of bankruptcy (Pet. App. 2a, 29a, 61a).

On May 6, 1963, and March 24, 1964, statutory notices of deficiency were mailed to petitioners Abner and Alyce Michaud, with respect to proposed defi-

ciencies in federal income taxes for the years 1955 through 1960 (years in which they filed joint federal income tax returns); within 90 days of receiving each of these notices, the Michauds filed petitions for redetermination of the deficiencies in the Tax Court (Pet. App. 34a, 59a-60a). The Tax Court cases were pending at the time the Michauds filed petitions under the Bankruptcy Act, and it was stipulated that the issues in the Tax Court proceedings should be determined by the bankruptcy court (Pet. App. 60a-61a).[1]

The income tax deficiencies in question related to income derived by Abner Michaud from his 95 percent partnership interest in a meat processing and distribution business. In dispute was the disallowance by the Internal Revenue Service of deductions claimed on the partnership tax return with respect to certain payments of 3 percent commissions to managers, chefs, and other purchasing agents of customers of the partnership. The referee held that these payments constituted nondeductible "kickbacks," and he allowed the government's claim in the sum of $94,652.73, plus interest to the date of filing of the

[1] The bankruptcy proceedings began as a petition by Abner Michaud for an arrangement under Chapter XI of the Bankruptcy Act; on October 4, 1966, he was adjudicated a bankrupt on his consent thereto and withdrawal of the arrangement proceeding (Pet. App. 32a). Alyce Michaud filed a petition in voluntary bankruptcy and was adjudicated a bankrupt on May 4, 1966 (Pet. App. 32a). An order was subsequently entered consolidating the separate proceedings (Pet. App. 52a).

arrangement petition and "the amount due for the year 1960 on taxable income not in excess of $44,000 and said interest" (Pet. App. 52a). The referee, however, sustained the objections of petitioners (including the trustee) to the allowance of this claim as a priority tax claim under Section 64a(4) of the Bankruptcy Act (*ibid.*) The district court affirmed both the disallowance of the claimed deductions and denial of priority to the government's claim (Pet. App. 29a-30a). On the government's appeal, the court of appeals reversed, holding that the tax claims were entitled to priority (Pet. App. 2a, 14a).

ARGUMENT

The decision below is correct. There is no conflict among the courts of appeals nor any other consideration warranting further review of this case.

Section 17a(1) of the Bankruptcy Act, 11 U.S.C. 35(a)(1), provides generally for discharge in bankruptcy of provable debts for taxes that became legally due and owing more than three years preceding bankruptcy.[2] However, this provision expressly excepts "taxes * * * which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt * * *."

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[2] It is conceded that the taxes here were due and owing more than three years preceding bankruptcy.

Since, as petitioners concede (Pet. 4), the taxes here were not assessed prior to bankruptcy, by reason of a prohibition on assessment pending disposition of the petitions filed in the Tax Court, the sole issue here is the narrow question whether the deficiencies determined by the referee related to "taxes * * * not reported on a return" and therefore were not discharged under Section 17a(1) of the Act.[3]

Petitioners contend (Pet. 5-13) that since the Michauds' tax returns set forth the amount and nature of their gross income and deductions, the returns included all information relevant to a determination of their tax liabilities and therefore the deficiencies here related to "taxes * * * reported on a return." In effect, petitioners argue that the word "taxes" in the statute should be read as if it meant "transactions" and that tax claims therefore are discharged unless they relate to "[transactions] * * * which were not reported on a return * * *."[4] Such a construction would violate both the plain language and the purpose of the statute.

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[3] Section 64a(4) of the Act, 11 U.S.C. 104(a)(4), provides that only taxes which are not discharged are entitled to priority.

[4] In support of this contention petitioners argue (Pet. 8) that the statute of limitations begins running upon the due date of a timely filed return fully disclosing gross income and deductions. However, the statute of limitations, Section 6501 of the Internal Revenue Code of 1954, 26 U.S.C. 6501, refers to the reporting of "gross income" and therefore, as the court of appeals correctly determined (Pet. App. 7a-8a), should not be interpreted in *pari materia* with the statute here, which refers to the reporting of "taxes."

The court below correctly reasoned that since the tax liabilities shown on the Michauds' returns were less than the tax liabilities finally determined, the deficiencies plainly related to "taxes * * * not reported on a return." See *In re Indian Lake Estates, Inc.*, 428 F. 2d 319 (C.A. 5), certiorari denied *sub nom. Stewart* v. *United States*, 400 U.S. 964. See generally 1A Collier, *Bankruptcy* § 17.14[4] (14th ed.).

This result is in accord with the statutory purpose. Prior to 1966, federal, state, and local taxes were not dischargeable in bankruptcy and all such taxes were entitled to priority of payment. In 1966 the Bankruptcy Act was amended to provide for discharge of tax claims in the limited circumstances described above (with additional exceptions not here relevant).[5] Pub L. 89-496, 80 Stat. 270. The objective of the amendment was to achieve a more effective rehabilitation of bankrupts and a more equitable distribution of bankrupts' assets among their creditors while at the same time recognizing the continued necessity of protecting the revenues. H. Rep. No. 687, 89th Cong., 1st Sess., pp. 3-4 (1965); S. Rep. No. 1158, 89th Cong., 2d Sess., pp. 3-4 (1966). The language used in the amendment gives effect to this general objective by reflecting a specific congressional determination that although stale tax claims should be discharged in bankruptcy, tax claims do not begin to

[5] Petitioners refer (Pet. 6-9) to legislative history illustrative of the broad intent of Congress to provide for the discharge of some tax claims. As the court below noted (Pet. App. 11a-13a), such history is of little help in deciding the reach of express exceptions to dischargeability.

grow stale until they are in a form that permits collection action by the Internal Revenue Service.[6] Since by virtue of the Michauds' contest of the proposed deficiencies in the Tax Court the taxes here had not become subject to collection prior to bankruptcy, the government's claim remained fresh; discharge of these claims would therefore unduly favor private creditors over the government and thus upset the balance intended by the 1966 amendment. Congress clearly did not intend that tax claims would become subject to discharge in bankruptcy before they become subject to collection.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1972.

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[6] Thus, as petitioners point out (Pet. 12), the result reached by the court of appeals will favor taxpayers against whom assessments are made more than one year prior to bankruptcy as against those who stave off assessment by contesting their liabilities. These consequences are not anomalous, but merely flow from the principle that, although stale claims are discharged, a claim may not be discharged before it becomes subject to collection.

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